# DOCKET

EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

No. 86-511-CFX
Status: GRANTED

Title: Commissioner of Internal Revenue, Petitioner
v.
Peter R. Fink, et ux.

Docketed:
September 26, 1986

Court: United States Court of Appeals
for the Sixth Circuit

See also:
86-11

Counsel for petitioner: Solicitor General

Counsel for respondent: Wilson, Mark K., Zinn, Matthew J., Jones Jr., W. Merritt

| Entry | Date | Note | Proceedings and Orders |
|---|---|---|---|
| 1 | Jul 15 1986 | | Application for extension of time to file petition and order granting same until September 27, 1986 (O'Connor, July 18, 1986). |
| 2 | Sep 26 1986 | G | Petition for writ of certiorari filed. |
| 3 | Oct 29 1986 | | DISTRIBUTED. November 14, 1986 |
| 4 | Nov 3 1986 | X | Brief of respondents Peter Fink, et ux. in opposition filed. |
| 5 | Nov 17 1986 | | Petition GRANTED. |
| | | | ********** |
| 6 | Dec 10 1986 | G | Motion of The Solicitor General to dispense with printing the joint appendix filed. |
| 8 | Dec 29 1986 | | Order extending time to file brief of petitioner on the merits until January 23, 1987. |
| 9 | Jan 12 1987 | | Motion of The Solicitor General to dispense with printing the joint appendix GRANTED. |
| 10 | Jan 23 1987 | | Order further extending time to file brief of petitioner on the merits until January 28, 1987. |
| 11 | Jan 28 1987 | | Brief of petitioner CIR filed. |
| 13 | Feb 6 1987 | | Order extending time to file brief of respondent on the merits until March 21, 1987. |
| 14 | Feb 13 1987 | | Record filed. |
| 15 | Feb 13 1987 | | Certified copy of C. A. proceedings received. |
| 16 | Feb 19 1987 | | Record filed. |
| 17 | Feb 19 1987 | | Certified copy of Tax Court record received. |
| 18 | Mar 11 1987 | | SET FOR ARGUMENT. Monday, April 27, 1987. (1st case). |
| 19 | Mar 20 1987 | | Brief of respondent Peter R. Fink, et ux. filed. |
| 20 | Mar 20 1987 | | Brief amicus curiae of Leroy Frantz, Jr. filed. |
| 21 | Mar 25 1987 | | CIRCULATED. |
| 22 | Apr 20 1987 | X | Reply brief of petitioner CIR filed. |
| 23 | Apr 27 1987 | | ARGUED. |

# PETITION FOR WRIT OF CERTIORARI

86-511

No.

Supreme Court, U.S.
FILED
SEP 26 1986
JOSEPH F. SPANIOL, JR.
CLERK

# In the Supreme Court of the United States

OCTOBER TERM, 1986

---

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

---

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

---

CHARLES FRIED
*Solicitor General*

ROGER M. OLSEN
*Assistant Attorney General*

ALBERT G. LAUBER, JR.
*Deputy Solicitor General*

ALAN I. HOROWITZ
*Assistant to the Solicitor General*

JONATHAN S. COHEN
DAVID I. PINCUS
*Attorneys*

*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

58pp

## QUESTION PRESENTED

Whether the surrender by a corporation's dominant shareholders of a small portion of their shares in order to improve the corporation's financial position gives rise to an immediately deductible loss in the computation of the shareholders' taxable income.

## TABLE OF CONTENTS


| | Page |
|---|---|
| Opinions below | 1 |
| Jurisdiction | 1 |
| Statutes involved | 2 |
| Statement | 2 |
| Reasons for granting the petition | 5 |
| Conclusion | 17 |
| Appendix A | 1a |
| Appendix B | 21a |
| Appendix C | 23a |
| Appendix D | 34a |


## TABLE OF AUTHORITIES

Cases:


| | |
|---|---|
| *Arrott* v. *Commissioner*, 136 F.2d 449 | 12 |
| *Commissioner* v. *Auto Strop Safety Razor Co.*, 74 F.2d 226 | 10 |
| *Davidson* v. *Commissioner*, 305 U.S. 44 | 12 |
| *Deputy* v. *du Pont*, 308 U.S. 488 | 11 |
| *Eskimo Pie Corp.* v. *Commissioner*, 4 T.C. 669, aff'd, 153 F.2d 301 | 11 |
| *Frantz* v. *Commissioner*, 83 T.C. 162, aff'd, 784 F.2d 119, petition for cert. pending, No. 86-11 | 3, 4, 6, 7, 8, 9, 14, 17 |
| *Helvering* v. *Rankin*, 295 U.S. 123 | 12 |
| *Ihrig* v. *Commissioner*, 26 T.C. 73 | 11 |
| *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590 | 11 |
| *Kistler* v. *Burnet*, 58 F.2d 687 | 14 |
| *Rittenberg* v. *United States*, 267 F.2d 605, cert. denied, 361 U.S. 931 | 11 |
| *Schleppy* v. *Commissioner*, 601 F.2d 196 | 4, 6, 7, 8 |
| *United States* v. *Davis*, 397 U.S. 301 | 15 |

| Statutes and regulations: | Page |
|---|---|
| Internal Revenue Code of 1954 (26 U.S.C.): | |
| § 165 | 2 |
| § 165(c)(2) | 9 |
| § 165(f) | 9 |
| § 165(g)(1) | 9 |
| § 302 | 16 |
| § 302(a) | 15 |
| § 302(b) | 15 |
| § 302(b)(2) | 15 |
| § 302(b)(2)(B) | 15 |
| § 302(c) | 15 |
| § 302(d) | 15 |
| § 317(b) | 15 |
| § 1001(a) | 12 |
| § 1016(a)(1) | 2, 10 |
| § 1211 | 9 |
| § 1211(b) | 9 |
| Treas. Reg. 45, art. 51 (1918) | 10 |
| Treas. Reg.: | |
| § 1.61-12(a) | 10, 14 |
| § 1.263(a)-2(f) | 10 |
| § 1.302-2(c) | 15 |
| § 1.302-3 | 15 |
| § 1.1012-1(c)(1) | 12 |
| Miscellaneous: | |
| Brodsky & Pincus, *The Case of the Reappearing Basis*, 34 Taxes 675 (1956) | 15 |
| Gebhardt, *When Are Loss Deductions Available on the Voluntary Surrender of Stock?*, 43 J. Tax. 22 (1975) | 9 |
| Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 Va. Tax Rev. 81 (1983) | 12 |
| Comment, Frantz *v.* Commissioner, *Non Pro Rata Surrender of Stock to the Issuing Corporation*, 38 Tax Law. 739 (1985) | 6 |


# In the Supreme Court of the United States

OCTOBER TERM, 1986

---

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

---

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

---

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

### OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-20a) is reported at 789 F.2d 427. The opinion of the Tax Court (App., *infra*, 23a-33a) is unofficially reported at 48 T.C.M. (CCH) 786.

### JURISDICTION

The judgment of the court of appeals (App., *infra*, 21a-22a) was entered on April 30, 1986. On July 18, 1986, Justice O'Connor extended the time for

filing a petition for a writ of certiorari to and including September 27, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATUTES INVOLVED

The relevant portions of Sections 165 and 1016(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in the Appendix, *infra*, 34a-35a.

## STATEMENT

1. Respondents Peter and Karla Fink, who are husband and wife, were the principal shareholders of Travco Corporation (App., *infra*, 2a). Travco had one class of common stock outstanding, of which Peter owned 52.2% and Karla 20.3% (*id.* at 27a, 30a). When the corporation encountered financial difficulties (see *id.* at 25a-27a), respondents surrendered a portion of their shares to the corporation in order "to improve [its] financial position, to preserve its business, and to increase [its] attractiveness * * * to outside investors" (*id.* at 3a, 28a). Specifically, Peter surrendered 116,146 of his 802,300 shares in 1976, and Karla surrendered 80,000 of her 311,359 shares in 1977. No other shareholder surrendered any shares. *Id.* at 28a-30a. By virtue of these stock surrenders, respondents reduced their combined interest in the corporation from 72.5% of the outstanding shares to 68.5% (*id.* at 30a, 32a). For federal income tax purposes, respondents claimed the entire amount of their cost or "basis" in the surrendered shares—$197,782 for Peter and $191,258 for Karla—as ordinary loss deductions on their 1976 and 1977 joint tax returns (*id.* at 3a-4a).

2. The Commissioner disallowed the claimed deductions. He determined that respondents' surrenders of stock to their corporation did not generate currently deductible losses, but rather constituted contributions to the corporation's capital (App., *infra*, 32a). He accordingly determined deficiencies of $131,885 for 1976 and $133,826 for 1977 (*id.* at 23a).



Petitioners sought redetermination of the deficiencies in the Tax Court. That court sustained the Commissioner's position, relying on its reviewed decision in *Frantz* v. *Commissioner*, 83 T.C. 162, 174-182 (1984), aff'd, 784 F.2d 119 (2d Cir. 1986), petition for cert. pending, No. 86-11, which was decided the same day. In *Frantz*, the Tax Court held that a stockholder's non-pro-rata surrender of shares to his corporation does not entitle him to deduct his basis in those shares as an immediate loss; rather, his basis in the surrendered shares must be added to his basis in the shares he retains. The Tax Court explained (83 T.C. at 181) that "[t]his conclusion * * * necessarily follows from a recognition of the purpose of the transfer, that is, to bolster the financial position of [the corporation] and, hence, to protect and make more valuable [the stockholder's] retained shares." Because the stockholder in surrendering his shares was "attempting to decrease or avoid a loss on his overall investment," the Tax Court was "unable to conclude that [he] sustained a loss at the time of the transaction." Instead, the court concluded, "[w]hether [he] would sustain a loss, and if so, the amount thereof, could only be determined when he subsequently disposed of the stock that the surrender was intended to protect and make more valuable" (*ibid.*). The Tax Court accordingly held in the instant case that respondents' stock surrenders did not give rise to immediately deductible losses, but rather

must be treated as contributions to Travco's capital (App., *infra*, 32a-33a).

3. A divided court of appeals reversed (App., *infra*, 1a-20a). According to the majority's analysis, the outcome depended on whether it was proper to adopt a "unitary" or a "fragmented" view of stock ownership for purposes of the present case (see *id.* at 4a-10a). Under the "fragmented" view, "each share of stock is considered a separate investment," and gain or loss is computed separately on the sale or disposition of each share (*id.* at 5a). Under the "unitary" view, "the stockholder's entire investment is viewed as a single indivisible property unit," with the result that a sale or disposition of a portion of his shares can result in an ascertainable loss only "when the stockholder has disposed of his remaining shares" (*id.* at 5a, 12a (original quotation marks omitted)). The majority concluded that affirmance of the Tax Court would have required it to adopt the "unitary" view of stock ownership, and it declined to do so. In noted that each share of stock is normally treated as a separate unit for tax purposes, and it held that the particular situation involved here—a majority shareholder's non-pro-rata surrender of a small portion of his shares—presented "[in]sufficient justification for abandoning the '*fragmented view*'" (*id.* at 11a (emphasis in original)). The court of appeals specifically rejected the contrary holdings of the Second Circuit in *Frantz* v. *Commissioner*, *supra*, and of the Fifth Circuit in *Schleppy* v. *Commissioner*, 601 F.2d 196 (1979), both of which had held that similar stock surrenders did not give rise to an immediate loss deduction.

Judge Joiner dissented (App., *infra*, 17a-20a). He pointed out that where, as here, "the taxpayers' sole motivation in disposing of certain shares is to benefit



the other shares they hold," the majority's insistence upon "[v]iewing the surrender of each share as the termination of an individual investment ignores the very reason for the surrender" (*id.* at 20a). He emphasized that respondents had "reduced their corporate ownership only slightly * * * and [had] maintained their corporate control," so that they remained after the stock surrender "in substantially the same position that they previously held [and had] not suffered any sort of meaningful loss" (*id.* at 18a). "Particularly in cases * * * where the diminution in the shareholder's corporate control and equity interest is so minute as to be illusory," Judge Joiner reasoned, "the stock surrender should be regarded as a contribution to capital" (*id.* at 20a). He accordingly concluded that, "[w]hatever validity the 'fragmented view' may have outside of the present context, it should not be applied here" (*id.* at 19a).

## REASONS FOR GRANTING THE PETITION

The court of appeals has created a direct conflict with the decisions of two other circuits concerning an important question of tax law—the proper treatment for income tax purposes of a stockholder's non-pro-rata surrender of corporate shares. Because this issue has been a recurring one, and because the court of appeals' erroneous decision raises the possibility that taxpayers will be encouraged to make such surrenders to gain an undeserved and improper tax advantage, it appears likely that the conflict, if allowed to persist, will result in disparate tax treatment for a significant number of taxpayers. Review by this Court is warranted to resolve this conflict in the circuits and to correct the mistaken statutory interpretation of the decision below.

1. The court of appeals in this case has taken the position that a shareholder's non-pro-rata surrender of stock entitles him to an immediate loss deduction. The amount of this deduction will typically be measured by the taxpayer's cost or "basis" in the surrendered stock, with perhaps some adjustment for any increase in value of his remaining shares that is attributable to the surrender. See App., *infra*, 14a; Comment, Frantz *v.* Commissioner, *Non Pro Rata Surrender of Stock to the Issuing Corporation*, 38 Tax Law. 739, 742 (1985). The court of appeals' holding to this effect squarely conflicts with the decisions of the Second Circuit in *Frantz* v. *Commissioner*, *supra*, and the Fifth Circuit in *Schleppy* v. *Commissioner*, *supra*.

In *Frantz*, the dominant shareholder had sought to improve the corporation's financial condition by surrendering his preferred stock (784 F.2d at 121). The court of appeals affirmed the Tax Court's decision that the taxpayer was not entitled to an immediate loss as a result of this surrender. The court explained that "it is questionable whether a controlling stockholder who voluntarily surrenders stock to his corporation for the purpose of strengthening it but continues his control through stock retained by him, thereby benefiting from the surrender, necessarily suffers any recognizable loss at the time of the surrender" (*id.* at 125). Because the change in the taxpayer's interest in the corporation as a result of the surrender "was miniscule compared with [his] retained interest in the company," the Second Circuit in *Frantz* concluded that the surrender should not be treated as giving rise to an immediate loss but rather should be regarded "as a non-deductible capital expenditure" (*ibid.*).



The Fifth Circuit in *Schleppy* similarly held that a controlling shareholder's "surrender of a very small part of [his] stockholdings * * * to the corporation itself to improve its financial position" did not give rise to a currently deductible loss (601 F.2d at 199). Speaking for a unanimous court, Judge Tuttle noted "the general proposition that voluntary payments by a stockholder to his corporation in order to bolster its financial position cannot be claimed as a loss," but rather must be "added to the basis of the stock in the stockholder's hands" (*id.* at 197). "It is difficult to perceive why any distinction should arise," the court continued, "if, instead of paying cash to the corporation, the shareholder surrenders part of his shares to bolster [its] financial health" (*ibid.*). The court noted that the dominant shareholders' surrender of their stock had reduced their controlling interest in the corporation only slightly—from 70.12% to 68.57%—and hence that the surrender had "left them in substantially the same position that they previously held" (*id.* at 198). The court concluded that the shareholders' action could not be characterized as generating a "loss" and held that their basis in the shares surrendered "is to be added to their basis in their remaining shares" (*id.* at 198-199).

The decision below cannot be reconciled with *Frantz* or *Schleppy*. The inflexible rule adopted by the court below permits the immediate recognition of loss as a result of a non-pro-rata stock surrender, regardless of how insignificantly the surrendering shareholder's ownership interest is thereby reduced and regardless of whether he has suffered any loss as a practical matter. Indeed, the facts of the instant case, involving a stock surrender that reduced the taxpayers' controlling interest from 72.5% to 68.5%, are substantially identical to the facts in *Schleppy*, where the

stock surrender reduced the taxpayers' controlling interest from 70.1% to 68.6%. Compare App., *infra*, 30a with 601 F.2d at 198. There can thus be no doubt that cases identical to *Schleppy* or *Frantz* would be decided in favor of the taxpayer's request for immediate loss recognition should they arise in the Sixth Circuit. Indeed, the court of appeals below made no attempt to harmonize its decision with *Frantz* and *Schleppy*; it restricted its discussion of those cases to criticisms of their rationale. See App., *infra*, 12a-14a.[1]

2. Resolution of this direct conflict is a matter of substantial administrative importance. As the number of cases already decided suggests, the treatment of non-pro-rata stock surrenders has proven to be a recurring issue, and there is every reason to expect that litigation concerning this question will persist, and probably increase, in the wake of the court of appeals' decision here. That is especially true because acceptance of the taxpayer's position on this question, as the Tax Court noted in *Frantz*, would encourage the use of stock surrenders as a planning tool by which taxpayers might obtain unjustified tax advantages. See 83 T.C. at 182.

First of all, the decision below would permit taxpayers to accelerate their tax deductions, enabling them to recognize a currently deductible loss on a transfer which, if effected by the use of any property other

[1] The fact that the decision below cannot be squared with *Frantz* is highlighted by the fact that Judge Parker, the author of the dissent in *Frantz* (83 T.C. at 187-193), wrote the Tax Court decision below in favor of the Commissioner. Judge Parker in this case reiterated her view that *Frantz* had been wrongly decided (App., *infra*, 33a n.3), but she nevertheless concluded that the Tax Court's decision in *Frantz* could not be distinguished and was "dispositive" in the instant case (*id.* at 33a).



than corporate stock, would result in a nondeductible contribution to the corporation's capital. Moreover, the decision below could also permit "a conversion of eventual capital losses into immediate ordinary losses" (83 T.C. at 182). Under Section 165(g)(1) of the Code,[2] a loss on worthless stock is "treated as a loss from the sale or exchange * * * of a capital asset," and is thus subject to the limitation on deductibility of capital losses established in Section 1211. Because a unilateral surrender of stock would usually not be deemed to involve a "sale or exchange," however, a loss realized on such a surrender has been held in the past by the Tax Court not to be a capital loss but rather to be an ordinary loss deductible in full under Section 165(c)(2). See *Frantz*, 784 F.2d at 124-125; 83 T.C. at 182; I.R.C. §§ 165(f) and 1211(b). Thus, "[s]hareholders of a corporation on the verge of complete failure could * * * avoid the section 165 (g) limitations by surrendering shares in disproportionate amounts" just before their stock becomes completely worthless (83 T.C. at 182). For the courts to sanction such a result would, as the Tax Court observed (*ibid.*), effect "the practical equivalent of a judicial repeal of section 165(g)." The court of appeals in *Frantz* echoed these two themes, noting that acceptance of the taxpayer's position may give the surrendering taxpayer "an undeserved and illogical tax advantage" (784 F.2d at 124). See Gebhardt, *When Are Loss Deductions Available on the Voluntary Surrender of Stock?*, 43 J. Tax. 22 (1975) (suggesting the use of stock surrenders as a tax planning device).

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

The revenue consequences of stock-surrender transactions are generally quite substantial. In this case, for example, the tax deficiencies asserted for a stock surrender in which "the diminution in the shareholders' corporate control and equity interest [was] so minute as to be illusory" (App., *infra*, 20a (Joiner, J., dissenting)) exceed a quarter of a million dollars. It can thus be expected that the decision below will lead to increased litigation concerning the proper tax treatment of non-pro-rata stock surrenders unless this Court intervenes to resolve the existing conflict in the circuits.

3. The court of appeals' approval of an immediate loss deduction for a non-pro-rata stock surrender is a serious misapplication of tax law principles. It has long been established that transfers by a shareholder to his corporation are treated, not as losses, but as contributions to capital that have no immediate tax consequences. The Treasury Regulations provide that "if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt." Treas. Reg. § 1.61-12(a).[3] More generally, "voluntary contributions by shareholders to the capital of the corporation for any corporate purpose" are regarded as "capital investments and are not deductible." Treas. Reg. § 1.263(a)-2(f). Pursuant to Section 1016(a)(1) of the Code, such contributions to capital result not in a loss but in an increase in the basis of the shareholder's shares by

[3] This provision dates back to Art. 51 of Regulations 45 under the Revenue Act of 1918. See *Commissioner* v. *Auto Strop Safety Razor Co.*, 74 F.2d 226 (2d Cir. 1934).



the amount of his basis in the debt or other property transferred.

These regulations reflect the general proposition, recognized by this Court in *Deputy* v. *du Pont*, 308 U.S. 488 (1940), that a shareholder may not take a deduction for outlays made to benefit his corporation. In *du Pont*, the taxpayer incurred certain expenses in connection with the transfer of some of his stockholdings to new executives of the corporation—a transaction that was undertaken because, "[f]or business reasons, [the corporation] thought it desirable that these men have a financial interest in the company" (308 U.S. at 490). The Court held that these expenses, because designed to further the corporation's business, did not give rise to a personal deduction for the taxpayer even though he hoped to derive some indirect benefit from them by virtue of his stock investment in the company (*id.* at 494). See also *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590 (1943). The lower courts have recognized that it necessarily follows from *du Pont* that transfers made to third parties for the benefit of one's corporation, like direct transfers to the corporation itself, result in an increase in the shareholder's basis in his shares. See, *e.g.*, *Rittenberg* v. *United States*, 267 F.2d 605 (5th Cir. 1959), cert. denied, 361 U.S. 931 (1960); *Eskimo Pie Corp.* v. *Commissioner*, 4 T.C. 669 (1945), aff'd, 153 F.2d 301 (3d Cir. 1946); *Ihrig* v. *Commissioner*, 26 T.C. 73 (1956). It thus follows inexorably from *du Pont* and its progeny that, contrary to the decision below, a shareholder's contribution of a portion of his stock to the corporation for the purpose of improving its financial condition yields an increase in the shareholder's basis in his remaining shares and does not give rise to an

immediate loss. See generally Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 Va. Tax Rev. 81 (1983).

The court of appeals failed to reach this result because it mistakenly perceived this case as turning on a supposed distinction between the "fragmented" and "unitary" views of stock ownership. See App., *infra*, 4a-10a. This alleged difference is in fact specious, and it provides no guidance whatever in resolving the question presented here. It is of course well settled that, if a person owns a piece of property and sells or exchanges it for other property, his gain or loss on the transaction is measured by the difference between his basis in the property sold or exchanged and the amount realized upon the sale or exchange (I.R.C. § 1001(a)). The same rule naturally applies to stock. An individual who owns shares in a corporation may have quite different bases in the several shares, depending on their purchase price and his mode of acquiring them. If he sells or exchanges some of the shares, his gain or loss is measured by the difference between the amount realized and the basis, or bases, of the particular shares sold or exchanged. See, *e.g.*, *Davidson* v. *Commissioner*, 305 U.S. 44 (1938); *Helvering* v. *Rankin*, 295 U.S. 123 (1935).[4] Only in very limited circumstances, such as after a corporate reorganization, will the differing bases of different blocks of stock be averaged and applied evenly to the total number of shares. See *Arrott* v. *Commissioner*, 136 F.2d 449 (3d Cir. 1943). Thus,

---

[4] In the absence of specific identification of shares, the Regulations provide that gains or losses are measured by assigning basis to the shares that are sold or exchanged on a first-in, first-out method. See Treas. Reg. 1.1012-1(c)(1).



stocks that are sold or exchanged are treated just like other types of property that are sold or exchanged, with gain or loss being computed by reference to their individual bases.

Our position in this case casts no doubt upon this well-settled rule, which the court of appeals would term the "fragmented" view of stock ownership. This case does not involve a sale or exchange. Rather, it involves a contribution to a corporation of property in the form of stock once issued by the corporation but now held by an individual shareholder. Just as a sale or exchange of stock is treated like the sale or exchange of other property, so too a surrender of stock should be treated like the surrender of other property. A shareholder's donation of cash or tangible property, or his surrender of indebtedness, is treated as a contribution to the corporation's capital that does not give rise to a deduction. There is no sound justification for treating a surrender of stock any differently. Regardless of what sort of property the shareholder decides to transfer to his corporation, his transfer is made for the purpose of enhancing or protecting the value of the shares he retains. The fact that his fellow shareowners will be benefitted to some extent by his transfer does not entitle him to a current tax deduction. And this result does not follow from any abstract distinction between "fragmented" and "unitary" views of stock ownership. It follows, rather, from (1) the significant difference between a shareholder's transfer of property to his own corporation and an arm's-length "sale or exchange," and (2) the lack of any significant difference between a shareholder's transfer of shares to his

corporation and his transfer of some other form of property to it.[5]

As the Second Circuit and the Tax Court explained in *Frantz* (see 784 F.2d at 123-124; 83 T.C. at 179-181), the fact that a shareholder's surrender of stock is intended to improve the financial position of his corporation—and hence to enhance the value of his remaining stock—means that the surrender itself does not result in any genuine and immediate loss to him. To the contrary, the surrender in reality is an "open transaction"; whether or not it will result in a loss depends upon the extent to which the surrender ultimately succeeds in enhancing the value of the taxpayer's remaining stock. That can be determined only when the transaction is "closed" by the disposition of his remaining shares. See also *Kistler* v. *Burnet*, 58 F.2d 687, 689 (D.C. Cir. 1932) (explaining that tax consequences of partial surrender will be assessed upon disposition of remaining shares).

4. Established principles regarding the tax treatment of stock redemptions further demonstrate that the court of appeals erred in allowing respondents a loss deduction for their non-pro-rata surrender of

---

[5] The error of the court of appeals' focus on the "fragmented" and "unitary" views of stock ownership becomes particularly clear when one considers the consequences that flow from a shareholder's surrender of *debt* to his corporation. If a shareholder surrenders some of his debentures, it is settled beyond any doubt that the transaction is a contribution to the corporation's capital, resulting in an adjustment of the shareholder's basis in his shares. See Treas. Reg. § 1.61-12(a). Clearly, this rule has never been thought to undermine the "fragmented" view of bond ownership—the rule that the sale or exchange of individual debt instruments is a taxable event even if the bondholder continues to hold other bonds from the same debtor.



shares to their corporation. A redemption occurs when a shareholder surrenders stock and receives cash or other property in return (I.R.C. § 317(b)). A redemption is treated as a "sale or exchange" of the stock, thereby giving rise to immediate recognition of gain or loss, only if there is a substantial, or "meaningful," reduction in the shareholder's interest in the corporation. *United States* v. *Davis*, 397 U.S. 301, 313 (1970); I.R.C. § 302(a), (b), and (d).[6] Absent such a substantial reduction in the shareholder's overall interest in the corporation, the redemption is broken down into two parts for tax purposes, with the receipt of cash or property being dissociated from the surrender of shares. The receipt of cash or property is generally treated as a dividend. See I.R.C. § 302(d). The surrender of shares results in no immediate gain or loss; rather, the shareholder's basis in the surrendered shares is added to his basis in the stock retained. See *United States* v. *Davis*, 397 U.S. at 307-308 n.9; Treas. Reg. § 1.302-2(c); Brodsky & Pincus, *The Case of the Reappearing Basis*, 34 Taxes 675, 676-677 (1956).

In this case, respondents' surrender of shares to their corporation reduced their interest in the corporation from 72.5% to 68.5%, a reduction that

---

[6] Congress has quantified the concept of a "meaningful" reduction under the rubric of a "substantially disproportionate" redemption. See I.R.C. § 302(b)(2); Treas. Reg. 1.302-3. Of particular relevance here, the "safe harbor" provision of Section 302 provides, as a threshold requirement that must be met before application of this provision can result in sale-or-exchange treatment, that the shareholder must hold less than 50% of the corporation's voting stock immediately after the redemption. I.R.C. § 302(b)(2)(B). Respondents here, of course, owned 68.5% of Travco's voting stock immediately after their stock surrender. See page 2, *supra*.

Judge Joiner correctly characterized as "so minute as to be illusory" (App., *infra*, 20a). If respondents had received any cash in conjunction with the surrender—even one penny a share—the surrender would have been treated as a redemption, the cash would have been treated as a dividend or other distribution, and respondents' basis in the surrendered shares would have been added to their basis in the shares retained. Because respondents received no cash, their transaction did not fall within the literal terms of the redemption provisions, and Section 302 therefore does not mandate the tax treatment just described. But it would indeed be a perverse result if respondents could secure the radically different tax treatment of an immediately deductible loss—and an ordinary rather than a capital loss—simply by foregoing a peppercorn of consideration.

Practically speaking, a stock surrender resembles a redemption for a zero dividend. More precisely, a stock surrender is equivalent to a redemption in which the quid-pro-quo for the shareholder is not the immediate and direct benefit of a cash dividend, but rather the more indirect and longer-term benefit of enhancing his overall investment in the corporation through the improvement of its financial condition. Thus, redemption principles strongly indicate that, when a shareholder makes a non-pro-rata stock surrender to improve the financial position of his corporation, maintaining the same effective control over the corporation that he had before, he has suffered no loss. The tax consequences of the transaction should therefore be the same as those that would attend a redemption of his shares, namely, the addition of the basis in the surrendered shares to the basis in the shares he retains.



5. As noted above, the decision in this case directly conflicts with *Frantz* v. *Commissioner*, *supra*, in which a petition for certiorari is pending, No. 86-11. We are filing contemporaneously with this petition a brief outlining our views in *Frantz*. As we explain in that brief (at 7-9), we believe that the instant case is somewhat preferable to *Frantz* as a vehicle for resolving the existing circuit conflict. It would therefore be appropriate for the Court to grant certiorari here and hold the petition in *Frantz* pending disposition of the instant case. Alternatively, the Court may wish to grant certiorari in *Frantz* and hold this case pending the outcome of that one.

## CONCLUSION

The petition for a writ of certiorari should be granted. Alternatively, if certiorari is granted in *Frantz* v. *Commissioner*, No. 86-11, the petition should be held and disposed of as appropriate in light of the disposition of that case.

Respectfully submitted.

CHARLES FRIED
*Solicitor General*

ROGER M. OLSEN
*Assistant Attorney General*

ALBERT G. LAUBER, JR.
*Deputy Solicitor General*

ALAN I. HOROWITZ
*Assistant to the Solicitor General*

JONATHAN S. COHEN
DAVID I. PINCUS
*Attorneys*

SEPTEMBER 1986

**APPENDIX A**

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

---

No. 84-1806

PETER R. FINK; KARLA S. FINK,
PETITIONERS-APPELLANTS

*v.*

COMMISSIONER OF INTERNAL REVENUE
RESPONDENT-APPELLEE

---

On Appeal from the United States Tax Court

---

Decided and Filed April 30, 1986

---

Before: KRUPANSKY and MILBURN, Circuit Judges; and JOINER, Senior District Judge*.

MILBURN, Circuit Judge, delivered the opinion of the Court, in which KRUPANSKY, Circuit Judge, joined. JOINER, Senior District Judge, (pp. 15-17) delivered a dissenting opinion.

---

* The Honorable Charles W. Joiner, Senior Judge, United States District Court for the Eastern District of Michigan, sitting by designation.

MILBURN, Circuit Judge. Peter R. Fink and Karla S. Fink ("taxpayers") appeal from a decision of the United States Tax Court determining deficiencies in taxpayers' federal income taxes for 1976 and 1977. The taxpayers claimed that their non-pro rata surrender of stock to the issuing corporation entitled them to an ordinary loss under section 165 of the Internal Revenue Code (the "Code"), 26 U.S.C. § 165. The Tax Court held that a non-pro rata surrender of shares to the issuing corporation to improve its financial position is not an event that permits the recognition of loss and constitutes, instead, a contribution to the corporation's capital. For the reasons that follow, we reverse.

I.

Taxpayers were the principal stockholders of Travco Corporation. Throughout the 1970's, the largest part of Travco's business involved the manufacture and sale of motor homes, recreational vehicles, and their component parts. The energy crisis of 1973 and 1974 caused a decline in the market for motor homes and recreational vehicles, resulting in a decline in earnings and a weakening of Travco's financial condition.

At the time of the energy crisis and following, Travco enjoyed a line of credit with Manufacturers National Bank of Detroit of $3,000,000 to $3,400,000. Because of Travco's weakened financial condition, Manufacturers National became concerned about Travco's ability to repay its borrowings. During 1976 Manufacturers National put pressure for repayment upon Travco. Travco's attempts to obtain new capital were unsuccessful, and late in 1976 Travco entered into negotiations with a new lender,



City National Bank of Detroit. As a condition of extending credit, City National required Travco to obtain $900,000 of new capital, $700,000 of equity and $200,000 of subordinated debt.

On December 22, 1976, Mr. Fink surrendered to Travco 116,146 shares of Travco's common stock having a total basis of $197,781.64. Mrs. Fink surrendered to Travco 80,000 shares of Travco common stock having a total basis of $191,257.61. No other shareholders surrendered any shares.

The purpose of the stock surrender was to improve Travco's financial position, to preserve its business, and to increase the attractiveness of the corporation to outside investors. The number of shares surrendered to the corporation was calculated to reduce the number of outstanding shares below 1.4 million and thus allow a new investor to acquire control of Travco by investing $700,000 in new $1.00 par value preferred stock convertible into 1.4 million shares of Travco common.

Prior to offering the new preferred stock to Travco's shareholders, Travco's directors passed a resolution authorizing the issuance of preferred stock to Mr. Fink, Mrs. Fink and Elise Fink (Mr. Fink's mother), if the other shareholders declined the offer. On February 25, 1977, after being unable to sell the stock to other persons, Travco sold $700,000 of its convertible preferred stock to Mr. and Mrs. Peter R. Fink and Elise M. Fink, and $200,000 of subordinated indebtednes to the same stockholders.

On their 1976 joint return, taxpayers claimed an ordinary loss of $197,781.64, representing the basis of the 116,146 shares of Travco stock surrendered by Mr. Fink. On their 1977 joint return, taxpayers claimed as a miscellaneous deduction an ordinary

loss of $191,257.61, representing the basis of the 80,000 shares of Travco stock that Mrs. Fink surrendered to the corporation. The Commissioner disallowed the claimed deductions, and the Tax Court affirmed.

In the Tax Court, the taxpayers relied on a long line of cases, culminating in *Smith v. Commissioner*, 66 T.C. 622 (1976), *rev'd sub nom. Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979), holding that a shareholder's non-pro rata surrender of stock to the issuing corporation results in an immediate ordinary loss. Following the Fifth Circuit's reversal of *Smith* in *Schleppy*, the Tax Court, in *Frantz v. Commissioner*, 83 T.C. 162 (1984), *aff'd*, No. 85-4062 (2d Cir. Feb. 19, 1986), overruled its prior line of cases and held that a non-pro rata stock surrender should be treated as a non-deductible contribution to capital. In the instant case, the Tax Court held in favor of the Commissioner on the basis of *Frantz*.

II.

In *Frantz*, the taxpayer owned 65% of the common stock and 13% of the preferred stock of Andree Biallot, Ltd. ("ABL"). In an effort to attract outside investors, the taxpayer contributed to the corporation his ABL preferred stock and his notes and accounts receivable representing debts owed him by ABL. This transfer was made without a proportionate surrender by other stockholders. Taxpayer claimed an ordinary loss deduction in the amount of the basis in the stock. The Commissioner disallowed the loss, and the Tax Court affirmed. *Frantz* held that a non-pro rata surrender of shares to the issuing corporation to improve its financial position should be characterized as a contribution to capital resulting



in the basis of the surrendered shares being added to the basis of the shares retained.

In *Frantz* the Tax Court determined the crucial question to be "whether the surrender constitutes a loss 'incurred in any transaction entered into for profit' within the meaning of section 165(c)(2)." 83 T.C. at 179. The Tax Court recognized that resolution of this issue required it to decide which of two competing views of stock ownership was applicable to this situation. Under the "*fragmented view*" of stock ownership each share of stock is considered a separate investment. A shareholder who surrenders shares to the issuing corporation is considered to have finally disposed of the particular shares surrendered. The surrender of the shares closes the transaction, and the shareholder is entitled to an immediate ordinary loss. *See Frantz*, 83 T.C. at 180. Under the "*unitary view*" of stock ownership the "stockholder's entire investment is viewed as a single indivisible property unit." *Frantz*, 83 T.C. at 188 (Parker, J., dissenting) The surrendering shareholder is recognized as having surrendered stock for the benefit of stock retained. The transaction remains open, and the surrendering shareholder must add the basis of the surrendered shares to the basis of the stock retained. *Frantz*, 83 T.C. at 180-81.

*Frantz* adopted the "*unitary view*" of stock ownership and concluded that the stock surrender did not constitute a loss event under section 165(c)(2) because there was no "closed transaction." According to *Frantz*, a non-pro rata stock surrender constitutes an open, non-taxable transaction in the nature of a capital contribution. Thus, whether the taxpayer suffered a recognizable loss could not be determined until there was a disposition of the retained shares. The Tax Court stated its decision as follows:

> This conclusion . . . necessarily follows from a recognition of the purpose of the transfer, that is to bolster the financial position of [the issuing corporation] and, hence, to protect and make more valuable petitioner's retained shares, and a consequent inability to fit the transaction within the statutory language authorizing a deduction for "losses incurred in any transaction entered into for profit."

83 T.C. at 181.

Relying on *Schleppy*, the Second Circuit affirmed the Tax Court's decision in *Frantz*. *Frantz v. Commissioner*, No. 85-4062 (2d Cir. Feb. 19, 1986). The court upheld treatment of the taxpayer's non-pro rata surrender as a non-deductible capital expenditure "[b]ecause the overall change in the taxpayer's interest in [the corporation] was miniscule compared with the taxpayer's retained interest in the company." *Frantz*, slip op. at 16. The court, however, cautioned that its holding "should not be construed as governing surrenders by a stockholder of more substantial equity interests that could truly be viewed as resulting in an immediate loss." *Frantz*, slip op. at ——.

Prior to *Frantz*, the Tax Court consistently held that non-pro rata stock surrenders gave rise to an immediate ordinary loss. *See, e.g., Smith v. Commissioner*, 66 T.C. 622, 650 (1976); *rev'd sub nom. Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979); *J.K. Downer v. Commisisoner*, 48 T.C. 86, 91 (1967); *Estate of Foster v. Commissioner*, 9 T.C. 930, 934 (1947); *Miller v. Commissioner*, 45 B.T.A. 292, 299 (1941). In *Foster* the Tax Court stated the general rule that "when a stockholder surrenders part of his stock to improve the financial condition of



the corporation he sustains a deductible loss, measured by the basis of the stock surrendered, less the resulting improvement in the value of the stock retained." 9 T.C. at 934. In *Downer* the Tax Court held that a taxpayer's transfer of a portion of his stock to an employee of the corporation for the purpose of inducing the employee to render services to the corporation resulted in an immediate deductible loss. 48 T.C. at 91. The decisions in *Downer* and *Foster* were premised on the "*fragmented view*" of stock ownership and both decisions explicitly refused to characterize the transfers as contributions to capital. *Downer*, 48 T.C. at 91; *Foster*, 9 T.C. at 934. In *Smith* the Tax Court reaffirmed its holdings in *Foster* and *Downer*. The Tax Court stated:

> It is well established that where a stockholder of a corporation surrenders some of his stock holdings to such corporation without consideration and such transfer results in a change of his proportionate ownership interest in that corporation, the stockholder is not treated as having made a contribution to capital but realizes any loss occasioned upon the surrender of such shares.

66 T.C. at 647.

In overruling its prior cases, the Tax Court relied on the Fifth Circuit's decision in *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979), *rev'g Smith v. Commissioner*, 66 T.C. 622 (1976), and this court's decision in *Tilford v. Commissioner*, 705 F.2d 828 (6th Cir.), *cert. denied*, 464 U.S. 992 (1983). In *Tilford* the shareholder of a corporation transferred stock to employees for the purpose of inducing them to accept or continue employment. The Commissioner

disallowed the claimed capital loss deductions and treated the transfers as capital contributions under Treas. Reg. § 1.83-6(d). Section 83(h) of the Code provides that in the event of a transfer of property which is subject to section 83, "there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred . . ." Treas. Reg. § 1.83-6(d) states in part:

> If a shareholder of a corporation transfers property to an employee . . . in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee. . . .

Unlike the instant case, the sole issue in *Tilford* was the validity of the Commissioner's interpretation of section 83(h) as set forth in Treas. Reg. § 1.83-6(d). Resolution of the issue hinged upon language found in the report of the Senate Finance Committee on the Tax Reform Act of 1960:

> In general, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of stock by the parent company or the shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the restricted property rules.

The Tax Court concluded that section 83(h) was an income provision and that it did not address itself to the tax consequences to a stockholder who provides



shares used in a restricted stock plan. Therefore, the Tax Court found Treas. Reg. § 1.83-6(d) outside the intended scope of the legislation. We, however, reversed the Tax Court and found Treas. Reg. § 1.83-6(d) consistent with the stated legislative purpose of section 83(h).

In *Schleppy*, the Fifth Circuit reversed the Tax Court's decision in *Smith* and held that the non-pro rata surrender of stock to improve the financial condition of the corporation did not result in an immediate ordinary loss to the taxpayers. The court concluded that the basis of the taxpayers in the shares surrendered should be added to their basis in their remaining shares. 601 F.2d at 199. *Schleppy* found that there was no loss " 'incurred in any transaction entered into for profit' " recognizable under section 165(c)(2). 601 F.2d at 199. *Schleppy* observed that "voluntary payments by a stockholder to his corporation in order to bolster its financial position cannot be claimed as a loss." 601 F.2d at 197. The court then wrote that it perceived no distinction between a shareholder paying cash to the corporation and a shareholder surrendering part of his shares to bolster the financial health of the corporation. *Id.*

The court in *Schleppy* criticized the Tax Court's reliance on the decisions in *Foster* and *Downer*. *Schleppy* interpreted *Foster* as holding that a shareholder's non-pro rata surrender of shares to the issuing corporation requires the basis of the surrendered shares to be added to the basis of the stock retained. 601 F.2d at 198. *Schleppy* distinguished *Downer* as involving a stock transfer to a third party and as requiring recognition of a loss where the surrender results in a significant reduction in the shareholder's percentage of ownership in the corporation. *Id.* The

shareholder's ownership in *Downer* decreased from 66.67 percent of the shares to just over 50 percent, whereas in *Smith* the shareholder's ownership decreased from 70.12 percent to 68.57 percent. *Id.*

In further support of its adoption of the "*unitary view*," *Frantz* suggested that the transaction entered into for profit began when the shares were surrendered. The Tax Court asserted that the profit sought was the increase in the value of the taxpayer's remaining stock investment. 83 T.C. at 181. Because it could not be determined whether the stock surrender would decrease or increase the value of the overall investment until the retained shares were disposed of, *Frantz* concluded that the transaction was not closed and that the taxpayer had realized no loss. *Id.*

*Frantz* also noted that its prior position would encourage "conversion of eventual capital losses into immediate ordinary losses." Section 165(g) provides that a security which becomes worthless during the taxable year will be treated as a loss from the "sale or exchange" on the last day of the taxable year. *Frantz* reasoned that a shareholder in a corporation on the verge of failure could avoid the section 165(g) limitations by surrendering the stock before it became valueless. 83 T.C. at 182. The Tax Court concluded that if its prior position were permitted to stand, the result would be "the practical equivalent of a judicial repeal of section 165(g)." *Id.*

III.

The Tax Court's "open transaction analysis" in *Frantz* is analytically sound only if we adopt a "*unitary view*" of stock ownership. 83 T.C. at 188 (Parker, J., dissenting). However, this court, like the Tax Court, has previously adhered to the "*fragmented view*" of stock ownership in determining the basis of stock sold or exchanged. *See Curtis v. United States*, 336 F.2d 714 (6th Cir. 1964); *Leake v. Commissioner*, 140 F.2d 451 (6th Cir. 1944), *cert. denied*, 323 U.S. 722 (1944). In *Leake* this court stated: "Fairness to both the taxpayer and the Government requires the allocation of cost on a share basis, and the cost deducted from each share as sold for the purpose of determining gain or loss." *Leake*, 140 F.2d at 453. Moreover, the tax law generally reflects a "fractional, divisible view of property, seeking to allocate basis and recognize gain or loss immediately when a larger part of the property is disposed of." *Frantz*, 83 T.C. at 189 (Parker, J., dissenting). *See also* Treas. Reg. § 1.61-6(a) (1960); *Byram v. Commissioner*, 555 F.2d 1234, 1235 (5th Cir. 1977); *Fasken v. Commissioner*, 71 T.C. 650, 655-57 (1979).



We do not believe that the facts of the instant case present sufficient justification for abandoning the "*fragmented view*" of stock ownership, a principle firmly rooted in the tax law and in this court's decisions. Each share of stock represents a permanent proprietary ownership or equity interest in the corporation. B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 14.31 (4th ed. 1979). The holder is entitled to a variety of rights, such as the right to receive dividends, the right to share in corporate assets on dissolution, and the right to vote on corporate matters. *Id.* With a non-pro rata surrender of stock, these rights are relinquished, and the shareholder's proportionate ownership interest is reduced. *Downer*, 48 T.C. at 91; *Frantz*, 83 T.C. at 189 (Parker, J., dissenting). Consequently, the surrendering shareholder suffers an immediate loss. The shareholder will enjoy a smaller

share of any future increase in corporate value. Moreover, any future income the shares would have earned through dividends or on liquidation is lost. The shareholder has incurred an economic loss that will not be fully accounted for by the increased basis of the retained stock.

Under the "*unitary view*," a non-pro rata surrender can only result in an ascertainable gain or loss when the stockholder has disposed of his remaining shares. Under this analysis, a shareholder who disposes of his shares at a gain, to enhance the value of his remaining stock investment, must postpone his recognition of that gain by reducing his basis in the remaining shares. He cannot have a cognizable gain because his disposition does not result in a "closed transaction." In light of the potential for abuse, it is doubtful that Congress would be willing to indefinitely delay recognition of gain on such a transfer. *Frantz*, 83 T.C. at 188. (Parker, J., dissenting).

The Second Circuit in *Frantz* and the Fifth Circuit in *Schleppy* adopted the "unitary view" of stock ownership because the shareholders incurred only a minimal reduction in their percentage of ownership as a result of the surrender. The courts speculated that the shareholders' net equity positions would not be substantially reduced after taking into account the increased value of the retained shares. *Frantz*, slip op. at —; *Schleppy*, 601 F.2d at 198. However, both courts indicated their willingness to allow an immediate ordinary loss where the surrender results in an impact of some undefined magnitude on the shareholders' interest in the corporation. *Frantz*, slip op. at —; *Schleppy*, 601 F.2d at 198. This reasoning addresses the size of the loss, not the question of recognition, and implicitly recognizes that the



value of the surrendered shares may not be fully absorbed by the retained shares. Moreover, this approach fosters uncertainty and will produce "much future litigation over the magnitude of impact of particular surrenders of stock." *Frantz*, slip op. at — (Winter, J., concurring).

Adoption of the "*unitary view*" is not supported by the suggestion by the Tax Court in *Frantz* and by the Fifth Circuit in *Schleppy* that the transaction entered into for profit began when the shares were surrendered, not when the shares were originally purchased. This reasoning ignores the well-settled principle that the profit objective for purposes of section 165(c)(2) is determined when the property is acquired. *See* B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶ 25.3 (1981). Judge Parker, dissenting in *Frantz*, wrote:

> Generally, the requisite profit objective for dealings in property is established (or not established) when the property is acquired. [citation omitted] The discussion of the taxpayer's reasons for surrendering the stock—enhancing the value of the corporation and hence the value of his remaining shares—is to negate the Government's argument that the surrender was a gift. [citation omitted] Once the taxpayer has disproved [the Commissioner's] claim that the stock surrender was for personal . . . reasons, the profit objective of his initial stock acquisition characterizes its disposition.

83 T.C. at 190. If the courts in *Schleppy* and in *Frantz* had followed the well-established "*fragmented view*," the transactions would have been closed at the time of the surrender and would have fit squarely within section 165(c)(2).

While we share in the Tax Court's concern for the prevention of sham transactions, we do not believe that our continued adherence to the "*fragmented view*" will effectively nullify section 165(g). As Judge Parker noted, the judiciary has developed numerous tests for tax evasion that can be applied to a stock surrender. *Frantz*, 83 T.C. at 192. The traditional tax common law doctrines, such as substance over form, sham transaction, step transaction and the business purpose rule, are sufficient to prevent any abuses that arise. *Id.* Moreover, the burden is on the taxpayer to prove the "bona fides" of the stock surrender.

Neither the Fifth Circuit's decision in *Schleppy* nor this court's decision in *Tilford* requires abandonment of the "*fragmented view*" of stock ownership. With respect to *Schleppy*, it is our view that *Foster* cannot be relied on for the proposition that a stock surrender requires the basis of the retained stock to be increased by the taxpayer's basis in the surrendered shares. In *Frantz* the majority and the dissent rejected *Schleppy's* interpretation of the decision in *Foster*. 83 T.C. at 176 n.11, 190. We, like the Tax Court, read *Foster* as holding that the taxpayer was allowed an immediate loss measured by the basis of the stock surrendered less any resulting increase in the value of the stock retained. 9 T.C. at 934.

Furthermore, we do not believe that *Downer* can be distinguished as involving a transfer to third parties rather than a surrender to the corporation. In our view, the fundamental issue in both the third-party transfer cases and in the direct surrender cases is whether either type of transfer constitutes a closed transaction that results in a recognizable loss. The difference between a transfer for consideration and



a direct surrender is relevant only for purposes of characterizing the resulting gain or loss. *Frantz*, 83 T.C. at 191 (Parker, J., dissenting).

Nor do we believe that the situation where a shareholder surrenders shares is indistinguishable from the circumstance where a shareholder gives cash or property to the corporation. When cash or property is given to the corporation, the corporation's capital is increased by the value of the property contributed. A true capital contribution represents an additional price paid for the stock. *See* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 3.14 (4th ed. 1979). The taxpayer's proportionate interest in the corporation remains unchanged and "the contribution will be reflected in an increased basis for his stock." *Id.* A non-pro rata stock surrender does not, however, represent an additional price paid for the stock. When a shareholder makes a non-pro rata surrender, corporate capital is not increased but the shareholder's proportionate percentage of ownership is reduced. *Smith*, 66 T.C. at 647; *Downer*, 48 T.C. at 91. As Judge Parker observed, we cannot disregard "the fact that a cash contribution does not change the shareholder's proportionate ownership interest in corporation vis-a-vis the other shareholders whereas the non-pro rata surrender of shares does." 83 T.C. at 191 (Parker, J., dissenting).

Our decision in *Tilford* is only applicable to section 83 transfers of property in connection with the performance of services. By enacting section 83, Congress altered the result reached in *Downer*. The legislative history of section 83 makes it clear that Congress intended to treat the transfer of stock by a shareholder to a corporate employee as a contribu-

tion of capital. Congress has not, however, altered the result reached in *Foster*. Congress is presumed to be aware of settled judicial construction and thus adopts that construction unless it affirmatively acts to change it. *See, e.g., Florida National Guard v. Federal Labor Relations Authority*, 699 F.2d 1082, 1087 (11th Cir.), *cert. denied*, 464 S.Ct. 1007 (1983). We therefore conclude that Congress intended the shareholder who engages in a non-pro rata stock surrender to have the benefit of an immediate loss.

V.

For the reasons stated, we REVERSE the decision of the Tax Court and REMAND for a determination of whether the surrender of the stock by the taxpayers resulted in an increase in the value of their remaining shares. Barring such a finding, taxpayers are entitled to an ordinary loss deduction for the full amount of their basis in the surrendered shares.



JOINER, Senior District Judge, dissenting. I respectfully dissent from the majority opinion, for I would affirm the decision of the Tax Court. The opinions of the Fifth Circuit in *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979), of the Second Circuit in *Frantz v. Commissioner*, No. 85-4062 (2d Cir. Feb. 19, 1986), and of this court in *Tilford v. Commissioner*, 705 F.2d 828 (6th Cir.), *cert. denied*, 464 U.S. 992 (1983), support this conclusion.

As indicated by the majority, *Schleppy* characterized two majority shareholders' non-pro rata surrender of slightly less than two percent of their stock to the issuing corporation as a non-deductible contribution to capital, rather than a deductible loss. The taxpayers' basis in the surrendered shares was therefore added to their basis in the remaining shares. 601 F.2d at 199. The court noted that a voluntary payment of cash to the corporation to bolster its financial position is considered a contribution to capital. The court found it "difficult to perceive why any distinction should arise if, instead of paying cash to the corporation, the shareholder surrenders part of his shares to bolster the corporation's financial health." *Id.* at 917. The Fifth Circuit then held that, in any event, the taxpayers had not demonstrated that they had suffered a genuine loss because of the surrender. The court observed that the taxpayers retained over 68% of the outstanding shares, thereby retaining corporate control while surrendering only a very small part of their holdings to improve the corporation's financial position. *Id.* at 198-99.

In its recent opinion in the *Frantz* case, the Second Circuit held that the taxpayer's non-pro rata stock surrender to a closely-held corporation, made

to enhance the value of the taxpayer's continuing investment by improving the company's financial condition, was a contribution to capital rather than an ordinary loss. The taxpayer had surrendered his non-voting preferred stock, but retained control of the corporation by continuing to hold 65% of the voting common stock. In deciding that the taxpayer had made a capital contribution, the Second Circuit emphasized that the stock surrender had not substantially reduced the taxpayer's net equity in the corporation. "Because the overall change in the taxpayer's interest in ABL was miniscule compared with the taxpayer's retained interest in the company, no justification exists for treating the change in value as a capital loss, much less as an ordinary one." Slip op. at 16.

As in the *Schleppy* and *Frantz* cases, the taxpayers here reduced their corporate ownership only slightly, in this case from 72% to 68%, and maintained their corporate control. Because the taxpayers' stock surrender left them in substantially the same position that they previously held, they have not suffered any sort of meaningful loss.

In *Tilford*, this court held that a taxpayer who sold stock at a loss to corporation employees to induce them to accept or continue employment made a capital contribution to the corporation, rather than suffered a deductible loss. *Tilford* found that Congress, by enacting Internal Revenue Code section 83, indicated that it viewed the transaction in two parts: the taxpayer's contribution of capital to the corporation, and the corporation's subsequent transfer of the stock as compensation to the employees. The majority distinguishes *Tilford* from the present case, stating that it merely affirms the validity of Treas.



Reg. § 1.83-6(d) as an interpretation of section 83. While *Tilford* relies on these provisions in reaching its conclusion, the opinion suggests that its holding should be accorded a broader meaning. It states that the reasoning of the *Schleppy* opinion "further explicate[s]" its conclusion. 705 F.2d at 831. *Tilford* also finds its result consistent with early Supreme Court tax cases holding that a shareholder cannot deduct payments made for the benefit of this corporation. *Id.* at 830 (citing *Deputy v. Dupont*, 308 U.S. 488 (1940) and *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943)).

The majority's attempt to distinguish *Tilford* from the present case presents a further difficulty. The majority's approach accords different tax treatment to a shareholder's transfer of stock to a third party for the benefit of the corporation, and a shareholder's direct surrender of stock to the corporation for the same purpose. It makes little theoretical sense to distinguish between these two transactions. In both cases, the shareholder parts with stock to protect or enhance the value of his remaining investment. Both transactions are best viewed as a contribution to capital.

The majority relies heavily on its perceived need to apply the "fragmented view" of stock ownership to the present case. It views each share of stock as a separate investment. The majority holds that the taxpayers are entitled to recognize immediate gains or losses when surrendering shares to the issuing corporation, as the taxpayers have finally disposed of the particular shares surrendered. Whatever validity the "fragmented view" may have outside of the present context, it should not be applied here. Each share cannot validly be regarded as a separate in-

vestment that is separately terminated, when the taxpayers' sole motivation in disposing of certain shares is to benefit the other shares they hold. The taxpayers surrendered their shares only because their action affected the value of other shares, making a continuing investment in the corporation feasible. Viewing the surrender of each share as the termination of an individual investment ignores the very reason for the surrender itself. Particularly in cases such as this, where the diminution in the shareholder's corporate control and equity interest is so minute as to be illusory, the stock surrender should be regarded as a contribution to capital.

For the foregoing reasons, I would affirm the decision of the Tax Court.



**APPENDIX B**

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

---

No. 84-1806

PETER R. FINK; KARLA S. FINK,
PETITIONERS-APPELLANTS

*v.*

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

---

[Filed Apr. 30, 1985]

---

JUDGMENT

Before: KRUPANSKY and MILBURN, Circuit Judges; and JOINER, Senior District Judge

On Appeal from a decision of the
Tax Court of the United States

THIS CAUSE came on to be heard on the transcript of record from the said Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the

decision of the said Tax Court in this cause be and the same is hereby reversed and the case is remanded consistent with this opinion.

Each party is to bear its own costs on appeal.

ENTERED BY ORDER OF THE COURT
JOHN P. HEHMAN, Clerk
/s/ John P. Hehman
Clerk



**APPENDIX C**

## UNITED STATES TAX COURT

T. C. Memo. 1984-418

PETER R. FINK and KARLA S. FINK, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22865-80 Filed August 7, 1984.

*Mark K. Wilson*, for the petitioners.

*Richard A. Witkowski*, for the respondent.

## MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, *Judge*: Respondent determined deficiencies in petitioners' 1976 and 1977 Federal income taxes in the respective amounts of $131,885 and $133,826. After a concession by petitioners, the issues remaining for decision are whether they are entitled to loss deductions for their non pro rata surrender of stock to the issuing corporation, and, if so, the measure of such losses.

## FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioners, Peter R. Fink (Mr. Fink) and Karla S. Fink (Mrs. Fink), husband and wife, resided in Grosse Pointe Farms, Michigan, at the time they filed their petition herein. Petitioners filed joint returns, Forms 1040, for 1976 and 1977, using the cash receipts and disbursements method of accounting. The returns were filed with the Internal Revenue Service Center in Cincinnati, Ohio.

In 1964, petitioners and five other individuals purchased Frank Motor Homes, Inc., a Michigan corporation that manufactured motor homes. During 1976 and 1977, Frank Motor Homes, Inc., was renamed Travco Corporation (Travco or the corporation). Beginning in 1964 and throughout the years in issue, Mr. Fink was the corporation's president and chief executive officer. At no time was Mrs. Fink involved in the corporation's management.

In the early 1970's Travco was a holding company conducting a variety of operations through subsidiaries. Travco manufactured motor homes through four operating subsidiaries. In addition, it operated a fiberglass parts and fiberglass bathtub-shower manufacturing business through a subsidiary (Richmond Products Company), and it manufactured seats, cushions, and fabrics for use in the interior of recreational vehicles through another subsidiary (Sanilac Company).

In July of 1971, Travco formed a wholly-owned subsidiary, Gemini Corporation (Gemini), to furnish on a contract basis the interiors for motor homes manufactured by the GMC Truck and Coach Division of General Motors Corporation (hereinafter GMC Truck and Coach). To perform its contract with GMC Truck and Coach, Gemini entered into a long-term lease for a plant of approximately 225,000



square feet. Gemini met its initial capital requirements by borrowing from the corporation and later, in October of 1973, by a $1,000,000 loan from GMC Truck and Coach, which was backed by Travco's credit.

Throughout the 1970's, the largest part of Travco's business involved the manufacture and sale of motor homes, recreational vehicles and their component parts. The energy crisis of 1973 and 1974 caused a change in consumer attitudes towards motors homes and recreational vehicles, resulting in a decline in earnings and a weakening of Travco's financial condition.

At the time of the energy crisis and following, Travco enjoyed a line of credit with Manufacturers National Bank of Detroit (Manufacturers National) of $3,000,000 to $3,400,000. Manufacturers National began to exert pressure on Travco for payment. Early in 1975, as a part of a new revolving credit agreement between Manufacturers National and Travco, Mr. and Mrs. Fink guaranteed payment of the corporation's borrowings against the line up to $200,000. Mr. and Mrs. Fink guaranteed the entire $200,000 because none of the other shareholders would guarantee any of it. For their guarantee, Travco issued petitioners stock warrants for up to 200,000 shares at $1.00 per share, the number of shares to be determined by the number of dollars they guaranteed to Manufacturers National.

From 1964 through 1976, Mr. Fink had invested approximately $835,000 in the stock of Travco and Mrs. Fink had invested approximately $1,060,000 in that stock. These stock investments were independent investment decisions. Mrs. Fink made her own decisions in all matters with regard to her own separate

estate and did so regarding any investments she made in Travco. Each of petitioners' stock investments in Travco was made with an actual and honest objective of making an economic profit.

During 1975 and the early part of 1976, GMC Truck and Coach drastically cut the production of its recreational vehicles, requiring Gemini to lay off the vast majority of its employees. Later, in 1976, GMC Truck and Coach ceased production of its recreational vehicles for an indeterminate period of time, leaving Gemini with substantial financial obligations. Because its own viability was threatened, Travco was forced to liquidate Gemini. Gemini or Travco or both had repaid approximately $212,000 of the $1,000,000 loan from GMC Truck and Coach. On or about December 8, 1976, GMC Truck and Coach compromised the remaining principal balance, plus accrued unpaid interest of approximately $153,000, for payment by Travco of $225,000. Travco had borrowed this $225,000 from Mr. Fink, who himself had borrowed it from the City National Bank of Detroit (City National). Gemini had previously compromised the balance of its lease obligation on its plant.

Because of Travco's liquidation of Gemini, its weakened financial condition, and market conditions generally, Manufacturers National became greatly concerned about the corporation's ability to repay its borrowings. During 1976, Manufacturers National put heavy pressure for payment upon Travco leaving it three choices—liquidating, finding a new lending bank, or obtaining new capital. During 1975 and 1976, Mr. Fink, on behalf of Travco, unsuccessfully sought additional capital for the corporation from various sources. He sought additional capital from another manufacturer of motor homes, from a Florida



investment group, from a Canadian company, and from his brother and brother-in-law, all without success.

Late in 1976, Travco was negotiating with City National to replace Manufacturers National as its lender. City National required $900,000 of new capital for the corporation, agreeing to $700,000 of equity and $200,000 of subordinated debt. City National also required the subordination of the corporation's $225,000 debt to Mr. Fink from the settlement with GMC Truck and Coach and of approximately $869,500 of additional shareholder-held debt, as well as personal guarantees from petitioners.

In an attempt to raise capital from sources other than its shareholders, Travco engaged an independent investment adviser, First of Michigan Corporation, to advise the corporation on how to attract outside investors and render an independent appraisal of the corporation's financial worth. In January of 1977, First of Michigan Corporation informed Travco that, without the infusion of new capital, its stock was worth about five cents a share.

Travco's capital structure, as of December 11, 1976, was as follows:

a. Common stock authorized—2,100,000 shares ($.25 par value)

b. Common stock outstanding—1,536,146 shares ($.25 par value)

c. Indebtedness in the amount of $350,000 to Mrs. Fink, subordinate only to bank indebtedness.

d. Indebtedness in the amount of $225,000 to Mr. Fink, subordinate only to bank indebtedness.

e. Indebtedness in the amount of $519,500 convertible for five years into Travco common stock at fifty cents ($.50) per share, with interest at the prime rate, payable quarterly, held as follows:

| | |
|---|---|
| Mr. Fink | $207,100 |
| Mrs. Fink | 212,400 |
| Elise F. Jones (Mr. Fink's sister) | 50,000 |
| Elise M. Fink (Mr. Fink's Mother) | 50,000 |

f. Guarantee to Manufacturers National Bank of Detroit in the amount of $200,000 by Mr. and Mrs. Fink, with petitioners holding warrants to purchase 200,000 shares of Travco's common stock at $1.00 per share.

On December 22, 1976, Mr. Fink surrendered without consideration 116,146 shares of Travco common stock to the corporation, shares having a total basis of $197,781.64. No other shareholder surrendered any shares. On January 6, 1977, Mrs. Fink surrendered without consideration 80,000 shares of Travco common stock to the corporation, shares having a total basis of $191,257.61. No other shareholder surrendered any shares. Travco held the shares surrendered by petitioners as treasury stock of zero value. At the time of the stock surrenders, the Travco stock was not worthless and had a value of at least five cents a share.

Petitioners surrendered a total of 196,146 shares to improve the corporation's financial position, to preserve its business, and to increase the attractiveness of the corporation to outside investors. Petitioners did not surrender stock as a part of any indirect transfer to a third party. The number of shares of stock that petitioners surrendered to the corporation



was calculated to allow a new investor to acquire control of Travco by investing $700,000 in new equity to be issued in the form of $1.00 par value preferred stock convertible into common shares on a 2:1 ratio.[1] Petitioner's stock surrenders were made for the business reasons stated above and were not primarily tax motivated.

Before Mr. Fink's surrender of shares on December 22, 1976, after his surrender of shares on that date, and after Mrs. Fink's surrender of shares on January 6, 1977, Travco's stock was owned as follows:

---

[1] In January 1977, following petitioners' surrender of the 196,146 common shares to Travco, there were 1,340,000 common shares outstanding. As discussed below, Travco intended to issue 700,000 shares of preferred stock, which, if converted into common, would give the investor voting control by giving him 1,400,000 common shares. While petitioners had $519,500 of corporate debt, convertible into common stock, because of petitioners' other debts and limited liquid assets, it would not have been practical for them to have converted that corporate debt into common stock. Therefore, there was little likelihood that petitioners could have regained voting control of the corporation had the 700,000 shares of preferred stock been purchased by an outside investor and converted into common stock.

| Name | Relationship to Mr. Fink | Holdings Before 12/22/76 Shares | % | Holdings After 12/22/76 Shares | % | Holdings After 1/6/77 Shares | % |
|---|---|---|---|---|---|---|---|
| Mr. Fink | — | 802,300 | 52.2 | 686,154 | 48.3 | 686,154 | 51.2 |
| Mrs. Fink | Wife | 311,359 | 20.3 | 311,359 | 21.9 | 231,359 | 17.3 |
| Elise F. Jones | Sister | 153,000 | 10.0 | 153,000 | 10.8 | 153,000 | 11.4 |
| W.M. Jones | Brother-in-law | 62,500 | 4.1 | 62,500 | 4.4 | 62,500 | 4.7 |
| Elise M. Fink | Mother | 33,333 | 2.2 | 33,333 | 2.2 | 33,333 | 2.4 |
| Hilborn Trust | | 4,000 | .2 | 4,000 | .3 | 4,000 | .3 |
| Jack Freeman | | 97,850 | 6.4 | 97,850 | 6.9 | 97,850 | 7.3 |
| David M. Jones | | 8,333 | .5 | 8,333 | .6 | 8,333 | .6 |
| Wayne F. Korn | | 5,125 | .3 | 5,125 | .4 | 5,125 | .4 |
| Thomas J. Fisher | | 58,346 | 3.8 | 58,346 | 4.1 | 58,346 | 4.4 |
| Totals | | 1,536,146 | 100.0 | 1,420,000 | 100.0 | 1,340,000 | 100.0 |





Travco had no preferred stock issued or outstanding on any of these dates.

In early 1977, as a result of its negotiations with City National regarding a loan and a revolving credit agreement for $3,000,000, Travco offered to its stockholders a $700,000 issue of eight percent $1.00 par value preferred stock, each share convertible into two shares of common, and $200,000 in subordinated notes. Prior to offering the eight percent convertible preferred stock to the corporation's stockholders, Travco's directors passed a resolution authorizing the issuance of the preferred stock to Mr. Fink, Mrs. Fink, and Elise M. Fink (Mr. Fink's mother), if the other stockholders declined to subscribe to the offering. The offer was made to the existing shareholders on a pro rata basis to allow them to maintain their equity positions in the corporation, although Mr. Fink did not expect any of the other shareholders to subscribe to any of the preferred stock. Mr. Fink's judgment proved correct. On February 25, 1977, after being unable to sell the stock to other persons, Travco sold $700,000 of its convertible preferred stock to Mr. and Mrs. Fink (233,333 shares to each) and to Mr. Fink's mother, Elise M. Fink (233,334 shares), and $200,000 of subordinated indebtedness due April 1, 1979 to the same stockholders (one-third to each). On or about April 14, 1977, Travco entered into a financing agreement with City National replacing Manufactures National as the corporation's principal bank. Mr. Fink guaranteed repayment on the corporation's line of credit.

During 1976, 1977, and 1978, Mr. Fink attempted unsuccessfully to sell or merge the corporation or components thereof. During 1978, 1979, and 1980, a substantial portion of Travco's assets were sold, its

creditors were paid to the extent possible, and the corporation was liquidated.

On their 1976 joint return, petitioners claimed as a miscellaneous deduction an ordinary loss of $197,781.64, representing the basis of the 116,146 shares of Travco common stock that Mr. Fink surrendered without consideration to the corporation. On their 1977 joint return, petitioners claimed as a miscellaneous deduction an ordinary loss of $191,257.61, representing the basis of the 80,000 shares of Travco common stock that Mrs. Fink surrendered without consideration to the corporation. In his statutory notice, respondent disallowed petitioners' claimed loss deductions, determining that their surrender of stock to the corporation merely constituted contributions to its capital.

OPINION

Petitioners surrendered shares of Travco stock (which the corporation then held as treasury stock) to enhance the financial condition of the corporation by enabling an outside investor to acquire control by subscribing to Travco's contemplated offering of convertible preferred stock and exercising the privilege to convert the preferred into common stock. These stock surrenders were not primarily tax motivated. None of the other Travco shareholders surrendered any stock, and petitioners' overall percentage interest in the corporation was reduced from 72.5 percent to 68.5 percent. Petitioners claimed ordinary loss deductions for their non pro rata surrender of stock to the corporation in 1976 and 1977.

Petitioners rely upon a long line of cases in this Court allowing an ordinary loss for disproportionate stock surrenders. See *Smith v. Commissioner*, 66 T.C. 622 (1976), revd. sub nom. *Schleppy v. Commissioner*, 601 F. 2d 196 (5th Cir. 1979); *Estate of*



*Foster v. Commissioner*, 9 T.C. 930 (1947); *Budd International Corp. v. Commissioner*, 45 B.T.A. 737 (1941), revd. on other grounds 143 F. 2d 784 (3d Cir. 1944); *Miller v. Commissioner*, 45 B.T.A. 292 (1941); *Wright v. Commissioner*, 18 B.T.A. 471 (1929), modified on another issue, 47 F. 2d 871 (7th Cir. 1931).[2] Respondent relies upon two recent appellate decisions denying loss deductions on disproportionate surrenders and similar dispositions. See *Tilford v. Commissioner*, 705 F. 2d 828 (6th Cir. 1983), revg. 75 T.C. 134 (1980); *Schleppy v. Commissioner, supra.* In *Frantz v. Commissioner*, 83 T.C. —— (filed August 7, 1984), this Court overruled the cases upon which petitioners rely and held that a non pro rata surrender of shares to the issuing corporation, like a pro rata surrender, is not an event that permits the recognition of loss and constitutes instead a contribution to the capital of the corporation. Thus, the taxpayer's basis in the surrendered shares must be added to his basis in his remaining shares. Our opinion in *Frantz v. Commissioner, supra*, is dispositive here.[3]

*Decision will be entered for the respondent.*

---

[2] See also *Duell v. Commissioner*, T.C. Memo. 1960-248; *Payne Housing Corp. v. Commissioner*, T.C. Memo. 1954-85.

[3] While I still adhere to the views expressed in my dissenting opinion in *Frantz v. Commissioner*, 83 T.C. —— (filed August 7, 1984), I of course accept the majority opinion as the law in this Court. Consistent with the views expressed in that dissenting opinion, I also think that the Sixth Circuit's *Tilford* opinion is not binding under our rule of *Golsen v. Commssioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971). Barring stipulation to the contrary, any appeal in this case will lie to the Sixth Circuit.

## APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. * * *

* * * * *

(f) *Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) *Worthless Securities.*—

(1) *General rule.*—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.



(2) *Security defined.*—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

Sec. 1016. ADJUSTMENTS TO BASIS

(a) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in Section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

* * * * *

☆ U. S. GOVERNMENT PRINTING OFFICE: 1986 491507 20328

# OPPOSITION

# BRIEF

FILED
NOV 3 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-511

# In the Supreme Court of the United States

OCTOBER TERM, 1986

---

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

---

*BRIEF FOR RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

---

MARK K. WILSON
HILL, LEWIS, ADAMS,
GOODRICH & TAIT
*Attorneys for Respondents*
*32nd Floor*
*100 Renaissance Center*
*Detroit, Michigan 48243*
*(313) 259-3232*

## QUESTION PRESENTED

Whether the non-pro rata surrender by a corporation's dominant shareholders of a portion of their shares of common stock in order to improve the corporation's financial position and make it a more attractive investment for outsiders gives rise to an ordinary loss in the year of surrender.

## TABLE OF CONTENTS


| | Page |
|---|---|
| Opinions below | 1 |
| Jurisdiction | 1 |
| Statement | 2 |
| Argument | 5 |
| Conclusion | 11 |


## TABLE OF AUTHORITIES


Cases:

- *Curtis v. United States*, 336 F.2d 714 (6th Cir. 1964) .. 7
- *J.K. Downer v. Commissioner*, 48 T.C. 86 (1967) ..... 4
- *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947) .. 4
- *Frantz v. Commissioner*, 83 T.C. 162 (1984), *aff'd*, 784 F.2d 119 (2d Cir. 1986), *petition for cert. pending*, (filed July 7, 1986) (No. 86-11) ..... 3,4,5,6,7,8,9,10,11
- *Leake v. Commissioner*, 140 F.2d 451 (6th Cir.), *cert. denied*, 323 U.S. 722 (1944) ..... 7
- *Miller v. Commissioner*, 45 B.T.A. 292 (1941), *acq.* 1941-2 C.B. 9, *acq. withdrawn nonacq. substituted* 1977-1 C.B. 2 ..... 4
- *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979) ..... 3,4,5,6,7,9,11
- *Smith v. Commissioner*, 66 T.C. 622 (1976), *rev'd sub nom. Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979) ..... 3,4

Statutes:

- Internal Revenue Code of 1954 (26 U.S.C.)
  - § 165(c)(2) ..... 4
  - § 165(g) ..... 10
  - § 302 ..... 8,9
- Tax Reform Act of 1986 (P.L. 99-514) ..... 9,10

# In the Supreme Court of the United States

OCTOBER TERM, 1986

---

No. 86-511

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

---

*BRIEF FOR RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

---

## OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-20a) is reported at 789 F.2d 427. The opinion of the Tax Court (*Id.* at 23a-33a) is unofficially reported at 48 T.C.M. (CCH) 786 (1984).

## JURISDICTION

The judgment of the court of appeals (Pet. App. 21a-22a) was entered on April 30, 1986. The petition for a writ of certiorari was filed on September 26, 1986 (within the extended period of time to file to and including September 27, 1986, granted by Justice O'Connor on July 18, 1986). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. Respondents, Peter R. and Karla S. Fink, who are husband and wife, were principal shareholders of Travco Corporation ("Travco"), which manufactured and sold motor homes, recreational vehicles and their component parts throughout the early 1970's. The energy crisis of 1973 and 1974 caused a decline in the market for motor homes and recreational vehicles, resulting in a decline in earnings and a weakening of Travco's financial condition (Pet. App. 2a).

From 1964 through 1976, Mr. Fink invested approximately $835,000 and Mrs. Fink approximately $1,060,000 in Travco common stock (Pet. App. 25a).

During 1976, Travco was pressured by its primary lender, Manufacturers National Bank of Detroit, to repay its borrowings. Late in 1976, Travco entered into negotiations with a new lender, City National Bank of Detroit, which, as a condition of extending credit, required Travco to obtain $900,000 of new capital, consisting of $700,000 in equity and $200,000 in subordinated debt (Pet. App. 2a, 3a).

On December 22, 1976, Mr. Fink surrendered to Travco 116,146 shares of common stock having a total basis of $197,781.64. On January 6, 1977, Mrs. Fink surrendered to Travco 80,000 shares of common stock having a total basis of $191,257.61. No other shareholder surrendered any shares (Pet. App. 3a, 28a). As a result of the stock surrenders, respondents' overall percentage interest in Travco was reduced from 72.5% to 68.5% (*Id.* at 30a).

The purpose of the stock surrenders was to improve Travco's financial position, to preserve its business, and to increase the attractiveness of the corporation to outside investors. The number of shares surrendered to the corporation was calculated to reduce the number of outstanding shares below 1.4 million and thus allow a new investor to acquire control of Travco by investing $700,000 in new $1.00 par value preferred stock convertible into



1.4 million shares of Travco common (Pet. App. 3a). The Tax Court found that the stock surrenders were not primarily tax motivated (*Id.* at 32a).

2. On their 1976 joint return, respondents claimed an ordinary loss of $197,781.64, representing the basis of the 116,146 shares of Travco stock surrendered by Mr. Fink. On their 1977 joint return, respondents claimed an ordinary loss of $191,257.61, representing the basis of the 80,000 shares of Travco stock surrendered by Mrs. Fink. The Commissioner disallowed the claimed deductions and the Tax Court affirmed (Pet. App. 3a, 4a).

In the Tax Court, respondents relied on a line of cases extending over a period of more than fifty-five years and culminating in *Smith v. Commissioner*, 66 T.C. 622 (1976), *rev'd sub nom. Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979). Those cases held that a shareholder's non-pro rata surrender of stock to the issuing corporation results in an immediate ordinary loss. In affirming the Commissioner's disallowance of the respondents' ordinary loss deductions, the Tax Court recognized this line of cases but concluded that the instant case was governed by its more recent decision in *Frantz v. Commissioner*, 83 T.C. 162 (1984), *aff'd*, 784 F.2d 119 (2d Cir. 1986), *petition for cert. pending*, (filed July 7, 1986) (No. 86-11) (Pet. App. 4a). In *Frantz*, the Tax Court had overruled the prior line of cases, holding that the non-pro rata stock surrender involved there would be treated as a non-deductible contribution to capital. The Tax Court's *Frantz* decision followed the Fifth Circuit's *Schleppy* decision, which reversed *Smith*, the last case in the fifty-five year chain of Tax Court cases holding that a non-pro rata surrender results in an immediate ordinary loss.

The court of appeals reversed the Tax Court's disallowance of respondents' ordinary loss deductions (Judge Joiner dissenting) (Pet. App. 1a-20a). The Court determined that the outcome depended on whether a "fragmented" or "unitary" view of stock ownership was followed (*Id.* at 4a-10a). Under the "fragmented" view, "each share

of stock is considered a separate investment," and gain or loss is computed separately on the sale, exchange or other disposition of each share (*Id.* at 5a). Under the "unitary" view, "the stockholder's entire investment is viewed as a single indivisible property unit," so that a sale, exchange or other disposition of a portion of his shares can result in an ascertainable loss only "when the stockholder has disposed of his remaining shares" (*Id.* at 5a, 12a (original quotation marks omitted)). The court of appeals adopted the "fragmented" view after concluding that it was more consistent with the various incidents of stock ownership.

Without reaching the "fragmented" versus "unitary" issue and relying partially on *Schleppy v. Commissioner*, the Second Circuit in *Frantz* concluded that the stock surrender there did not constitute a loss event under section 165(c)(2) of the Code.[1] The court upheld treatment of the taxpayer's non-pro rata surrender as a non-deductible capital expenditure "[b]ecause the overall change in the taxpayer's interest in [the corporation] was miniscule compared with the taxpayer's retained interest in the company." *Frantz*, 784 F.2d at 125. The Second Circuit cautioned that its holding "should not be construed as governing surrenders by a stockholder of more substantial equity interests that could truly be viewed as resulting in an immediate loss." *Frantz*, 784 F.2d at 126.

Prior to *Frantz*, the Tax Court had consistently held that non-pro rata stock surrenders give rise to an immediate ordinary loss since a shareholder's stock ownership is "fragmented". *See, e.g., Smith v. Commissioner*, 66 T.C. 622, 650 (1976), *rev'd sub nom. Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979); *J.K. Downer v. Commissioner*, 48 T.C. 86, 91 (1967); *Estate of Foster v. Commissioner*, 9 T.C. 930, 934 (1947); *Miller v. Commissioner*, 45 B.T.A. 292, 299 (1941). The court of appeals in the instant case specifically rejected the contrary holdings of the Second Circuit in *Frantz*, and of the Fifth Circuit in *Schleppy*, holding that the long-established Tax Court precedent was correct.

[1] All references to the Code are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended.



## ARGUMENT

Petitioner asserts an irreconcilable conflict between the Sixth Circuit's decision in this case and the Second Circuit's decision in *Frantz*. A petition for a writ of certiorari has been filed by the taxpayer in *Frantz*.

Respondents contend there is no irreconcilable difference between the cases and that the court of appeals in the instant case has correctly interpreted precedent. Respondents further contend that the issue in question is not of administrative importance. Accordingly, the petitions for a writ of certiorari presently before this Court in both cases should be denied.

### I

The Sixth Circuit Court of Appeals discussed at great length the basis upon which it reversed the Tax Court, which relied on *Frantz*. The court of appeals based its holding on the established legal principle that a non-pro rata stock surrender is a "fragmented" transaction (*i.e.*, each share is viewed separately for recognizing gain or loss) rather than a "unitary" transaction (*i.e.*, all owned stock is viewed as a whole and the recognition of any gain or loss is postponed until disposition of all shares).

In contrast, the Second Circuit *Frantz* court acknowledged but never decided the issue of whether a stock surrender is a "fragmented" or "unitary" transaction. It merely noted that certain practical and jurisprudential problems were posed by the "fragmented" and "unitary" theories. According to the court, the "unitary" theory inhibits stock surrenders by delaying loss recognition events and making them capital in nature while, on the

other hand, the "fragmented" theory often times results in undeserved and illogical tax advantages rather than the enhancement of the corporation's future value. The court also noted that measuring any loss under the "fragmented" theory, which is determined by taking the basis of the surrendered shares and subtracting any increase in the value of the shares retained, was difficult under the factual circumstances. *Frantz*, 784 F.2d at 125.

Stopping with the above analysis, the *Frantz* court concluded that "*in any event*" it was doubtful that the controlling shareholder in *Frantz* had suffered any recognizable loss at the time of the surrender. Several circumstances, all unrelated to the critical "fragmented" versus "unitary" issue, persuaded the court that the surrender in *Frantz* did not occasion a loss recognition event.

(1) The shareholder surrendered only 13% of the non-voting preferred stock of the corporation and maintained his 65% interest in the voting common stock.

(2) As in *Schleppy*, the taxpayer's net equity was not substantially reduced after taking into account the increase in value of the retained shares of stock. The court viewed the taxpayer's interest in the surrendered preferred shares as "miniscule" compared with his retained interest in the corporation. *Frantz*, 784 F.2d at 125. The taxpayer's basis in the preferred shares was $32,000 as compared to a basis of $150,000 in the common.

(3) There was no justification for capital or ordinary loss recognition on the surrender, and the court was disinclined to allow the taxpayer to manipulate his holdings for tax advantage.

(4) The surrender was treated as a contribution to capital in the corporate minutes.



Significantly, the Second Circuit's final pronouncement on the stock surrender issue was limited to the facts of that case:

> Our holding in this case, however, should not be construed as governing surrenders by a stockholder of more substantial equity interests that could truly be viewed as resulting in an immediate loss. *Frantz*, 784 F.2d at 126.

The Second Circuit Court of Appeals took the same approach in *Frantz* as the Fifth Circuit Court of Appeals took in *Schleppy*, ultimately concluding that the amounts involved were so "miniscule" that it was impossible to determine whether any loss actually was incurred by the taxpayer. Thus, rather than addressing the Tax Court's opaque legal conclusion that a "unitary" view of stock ownership was justified, the Second Circuit based its *Frantz* decision on practical considerations. *Schleppy's* similarly practical treatment of the problem is based upon, at least in part, a gross misreading of prior case law. *Schleppy* disposes of the issue on the supposedly practical consideration that the taxpayer's surrender of stock having a basis of $13,428.37 made it difficult for the court to determine whether a loss of any kind occurred.

Fifty-five years of Tax Court precedent and two cases in the Sixth Circuit, *Leake v. Commissioner*, 140 F.2d 451 (6th Cir. 1944), *cert. denied*, 323 U.S. 722 and *Curtis v. United States*, 336 F.2d 714 (6th Cir. 1964), hold that stock should be treated on a "fragmented" and not on a "unitary" basis. The United States Supreme Court should not be called upon to consider abandonment of this long-established rule on petitioner's assertion of a conflict among circuit courts where only one of the circuit courts has addressed the underlying issue of "fragmented" versus "unitary" stock ownership.

Nor should this Court consider such abandonment on the facts of this case, which differ markedly from those in *Frantz*.

(1) The taxpayers' basis in the shares surrendered in this case total $389,039 (hardly "miniscule" within

any reasonable interpretation of that word) as compared to $32,000 in *Frantz*.

(2) The stock surrendered in *Frantz* was non-voting preferred stock. The stock surrendered in this case was voting common, with its attendant voting rights, dividends, future appreciation, etc. Had the recapitalization of Travco resulted in an outside investor purchasing the offered convertible preferred stock, the taxpayers could have lost control of the corporation.

(3) The Tax Court found that the surrenders in this case were not primarily tax motivated.

(4) The record in this case demonstrates that the taxpayers "surrendered" their shares to the corporation and did not contribute shares to the capital of the corporation.

Petitioner's other arguments advanced in support of his petition for a writ of certiorari are also unconvincing. Petitioner again asserts that the principles regarding the tax treatment of stock redemptions should be applied to non-pro rata stock surrenders. Basically, section 302 of the Code differentiates between stock redemptions, which generally result in capital gain or loss to a taxpayer, and dividends, which constitute ordinary income. As respondents maintained before the court of appeals, section 302 is completely irrelevant to this case because it deals with distributions from a corporation to a shareholder in exchange for stock and there was no such distribution in this case.

Petitioner apparently believes that respondents did not have a substantial reduction in their interest in Travco following the stock surrenders and that they suffered "no loss" under the standards of section 302. To the contrary, respondents suffered a meaningful loss when they surrendered shares having a basis of $389,039 to enable a new investor to obtain control of the corporation. If the corporation had been successful in attracting a new investor, respondents' equity interest could have been reduced from 72.5% to 33.5%. In addition to placing themselves in a position to lose control of the corporation, respondents forever sacrificed their voting rights, rights to dividends, stock splits and their share of the corporate assets upon liquidation. Section 302 does not apply for the same reason that respondents suffered a loss of their total basis: they did not receive anything in return for their surrendered shares.



## II

The issue in this case is not of substantial administrative importance. In the more than fifty-five years during which the issue of a non-pro rata surrender of stock to a corporation to improve its financial position has been litigated, there have been approximately a dozen cases reported. Since the petitioner's 1979 success in *Schleppy*, exactly two cases, *Frantz* and this case, have reached the United States appellate court system. Two cases do not constitute a mass of litigation on this esoteric issue.

Both *Frantz* and *Schleppy* involve surrendered investments of $32,000 and $13,428.37, respectively. The instant case involves a total of $389,039. Accordingly, assuming 70% income tax brackets, two of the three cases which have been litigated through the appeals system in the last eight years involve deficiencies of less than $23,000.

The Tax Reform Act of 1986 (P.L. 99-514) was signed into law on October 22, 1986. Several provisions in that statute should reduce any tax benefits associated with non-pro rata stock surrenders and further negate several arguments made by the petitioner in support of his petition.

(1) In the years the respondents surrendered their shares of Travco stock, they were in marginal income tax brackets of 70%, resulting in tax deficiencies of $131,885 in 1976 and $133,826 in 1977. Had these surrenders been made in 1988 when the 15% and 28% brackets under the Tax Reform Act of 1986 will be fully in place, they would find themselves in a maximum marginal bracket of 28% resulting in deficiencies of approximately $55,379 and $53,552.

(2) The Tax Reform Act of 1986 repeals the long-term capital gain deduction, presently 60% of any net long-term capital gain. Capital gains will therefore be taxed on the same basis as ordinary income, although taxpayers will continue to net capital losses against capital gains and apply those net losses, if any, against ordinary income to the extent of $3,000 per year. Petitioner argues that allowing an ordinary loss on the non-pro rata surrender of stock in effect negates section 165(g) of the Code which provides that worthless securities constitute capital losses (generally long-term if held for more than six months). Taxing capital gains on the same basis as ordinary income will generally preclude this result, although the timing of any ordinary loss deduction against ordinary income is immediate while a capital loss applied against ordinary income is usually deferred to the future.

Petitioner argues that denying his petition will encourage stock surrenders as a planning tool and result in unjustified tax advantages to surrendering shareholders. As pointed out above, the Tax Reform Act of 1986 should generally preclude these potentialities. Further, as Tax Court Judge Parker stated in her dissent in *Frantz*, 83 T.C. at 192:

> . . . traditional tax common law doctrines (substance over form, step transaction, sham, etc.) are sufficient to deal with any abuses that arise. Moreover, the taxpayer bears the burden of proving his deductible loss. *Sack v. Commissioner*, [Dec. 24,032], 33 T.C. 805 (1960); *Clement v. Commissioner*, [Dec. 8571], 30 B.T.A. 757 (1934); Rule 142(a), Tax Court Rules of Practice and Procedure. This burden, in proper cases, would include the bonafides of his claimed motivation for the stock surrender. If a taxpayer surrenders shares with a genuine goal of preserving his corporation's existence (as opposed to an anticipatory triggering of a loss from a soon-to-be-worthless stock investment), I see no reason why, as a policy matter, an ordinary loss deduction should not be allowed.



The common law doctrines mentioned by Judge Parker are often used to plug holes in the Internal Revenue Code which can otherwise lead to abuse. These doctrines perform that function adequately in the context of non-pro rata stock surrenders.

## CONCLUSION

Both *Schleppy* and *Frantz* held that the taxpayer's non-pro rata surrenders of corporate stock did not result in ordinary losses because the factual record in each of those cases raised judicial doubts that losses of any kind were incurred. *Schleppy* held so partially on a misreading of prior law. *Frantz* relied on an equitable theory and entirely avoided the legal issues underlying a non-pro rata stock surrender.

The Sixth Circuit opinion in this case is based upon a thorough analysis of the legal principles set forth in fifty-five years of precedent and can be distinguished from *Schleppy* and *Frantz* on that basis. In addition, the issue involved is not of substantial importance to the administration of the federal income tax laws, now or in the future. Accordingly, respondents respectfully assert that the petitions for a writ of certiorari be denied in this case and in *Frantz*.

MARK K. WILSON
HILL, LEWIS, ADAMS,
GOODRICH & TAIT
*Attorneys for Respondents*
*32nd Floor*
*100 Renaissance Center*
*Detroit, Michigan 48243*
*(313) 259-3232*

Dated: October 31, 1986

# PETITIONER'S

# BRIEF

(3)

No. 86-511

Supreme Court, U.S.
FILED
JAN 28 1987
JOSEPH F. SPANIOL, JR.
CLERK

# In the Supreme Court of the United States

OCTOBER TERM, 1986

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

## BRIEF FOR THE PETITIONER

CHARLES FRIED
*Solicitor General*

ROGER M. OLSEN
*Assistant Attorney General*

ALBERT G. LAUBER, JR.
*Deputy Solicitor General*

ALAN I. HOROWITZ
*Assistant to the Solicitor General*

JONATHAN S. COHEN
DAVID I. PINCUS
*Attorneys*

*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

52 pp

## QUESTION PRESENTED

Whether the surrender by a corporation's dominant shareholders of a small portion of their shares in order to improve the corporation's financial position gives rise to an immediately deductible loss in the computation of the shareholders' taxable income.

## TABLE OF CONTENTS


| | Page |
|---|---|
| Opinions below | 1 |
| Jurisdiction | 1 |
| Statute involved | 1 |
| Statement | 2 |
| Summary of argument | 6 |
| Argument: | |
| Respondents' surrender of stock to their corporation in order to improve the corporation's financial condition does not give rise to an immediately deductible loss | 10 |
| A. A shareholder's transfer of property to his corporation, whether the property consists of stock or of other assets, is a contribution to capital that does not give rise to an immediate deduction | 10 |
| B. Allowing a shareholder to claim an immediate loss deduction for a stock surrender creates substantial tension with other provisions of the Code | 29 |
| 1. The law pertaining to stock redemptions indicates that stock surrenders do not generate an immediate loss | 29 |
| 2. The decision below may enable a stockholder in a failing corporation to avoid the tax consequences prescribed by Section 165(g) of the Code | 32 |
| 3. The court of appeals' proposed method of computing respondents' alleged "loss" is both unprecedented and impractical | 36 |
| Conclusion | 39 |
| Appendix | 1a |


## TABLE OF AUTHORITIES

Cases:


| | |
|---|---|
| *Ames* v. *Commissioner*, 14 B.T.A. 1067 (1929), aff'd, 49 F.2d 853 (8th Cir. 1931) | 4 |
| *Arrott* v. *Commissioner*, 136 F.2d 449 (3d Cir. 1943) | 21 |
| *Betson* v. *Commissioner*, 802 F.2d 365 (9th Cir. 1986) | 11 |

Cases – Continued: Page

*Boehm* v. *Commissioner*, 326 U.S. 287 (1945) ..... 15
*Boone* v. *Commissioner*, 33 T.C.M. (CCH) 662 (1974)... 22
*Bratton* v. *Commissioner*, 217 F.2d 486 (6th Cir. 1954)... 11
*Budd Int'l Corp.* v. *Commissioner*, 45 B.T.A. 737 (1941) . 33
*Commissioner* v. *Auto Strop Safety Razor Co.*, 74 F.2d 226 (2d Cir. 1934) ..... 11
*Davidson* v. *Commissioner*, 305 U.S. 44 (1938) ..... 21
*Deputy* v. *du Pont*, 308 U.S. 488 (1940) .....6, 11, 12
*Downer* v. *Commissioner*, 48 T.C. 86 (1967) ..... 4, 20, 26, 27, 28, 33
*Eisner* v. *Macomber*, 252 U.S. 189 (1920) ..... 13
*Eskimo Pie Corp.* v. *Commissioner*, 4 T.C. 669 (1945), aff'd, 153 F.2d 301 (3d Cir. 1946) ..... 12, 25
*Evans* v. *Rothensies*, 114 F.2d 958 (3d Cir. 1940) ..... 14
*Frantz* v. *Commissioner*, 83 T.C. 162 (1984), aff'd, 784 F.2d 119 (2d Cir. 1986), petition for cert. pending, No. 86-11 .....*passim*
*Harrison* v. *Schaffner*, 312 U.S. 579 (1941) ..... 37
*Helvering* v. *Rankin*, 295 U.S. 123 (1935) ..... 21
*Hoile* v. *Commissioner*, 4 T.C.M. (CCH) 247 (1945) ..... 14
*Ihrig* v. *Commissioner*, 26 T.C. 73 (1956) ..... 12, 25
*Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590 (1943) ..... 12
*Kistler* v. *Burnet*, 58 F.2d 687 (D.C. Cir. 1932) ..... 16
*Koree* v. *Commissioner*, 40 T.C. 961 (1963) ..... 12, 25
*Lidgerwood Manufacturing Co.* v. *Commissioner*, 229 F.2d 241 (2d Cir. 1956) ..... 15, 22
*Mack* v. *Commissioner*, 45 B.T.A. 602 (1941), aff'd, 129 F.2d 598 (2d Cir. 1942) ..... 14
*Perlman* v. *Commissioner*, 252 F.2d 890 (2d Cir. 1958), aff'g 27 T.C. 755 (1957) .....11, 13, 16
*Rittenberg* v. *United States*, 267 F.2d 605 (5th Cir. 1959), cert. denied, 361 U.S. 931 (1960) ..... 12, 25
*Sackstein* v. *Commissioner*, 14 T.C. 566 (1950) ..... 13
*Smith* v. *Commissioner*, 66 T.C. 627 (1976), rev'd *sub nom. Schleppy* v. *Commissioner*, 601 F.2d 196 (5th Cir. 1979) .....3-4, 5, 18, 19, 20, 24, 33
*South American Gold & Platinum Co.* v. *Commissioner*, 8 T.C. 1297 (1947), aff'd, 168 F.2d 71 (2d Cir. 1948) ... 12
*Thompson* v. *Commissioner*, 6 T.C. 285 (1946), aff'd, 161 F.2d 185 (2d Cir. 1947) ..... 22



Cases – Continued: Page

*Tilford* v. *Commissioner*, 75 T.C. 134 (1980), rev'd, 705 F.2d 828 (6th Cir.), cert. denied, 464 U.S. 992 (1983)... 3, 8, 27, 28
*Transport Mfg. & Equipment Co.* v. *Commissioner*, 27 T.C.M. (CCH) 924 (1968), aff'd, 431 F.2d 729 (8th Cir. 1970) ..... 14
*United States* v. *Davis*, 397 U.S. 301 (1970) ..... 9, 30
*Whitney* v. *Commissioner*, 8 T.C. 1015 (1947), aff'd, 169 F.2d 562 (2d Cir.), cert. denied, 335 U.S. 892 (1948) ... 16
*Wright* v. *Commissioner*, 18 B.T.A. 471 (1929), modified, 47 F.2d 871 (7th Cir. 1931) ..... 4

Statutes and regulations:

Internal Revenue Code (26 U.S.C. (& Supp. II)):
§ 83 ..... 26, 28
§ 83(h) .....8, 26, 27, 28, 29
§ 118 ..... 11
§ 165 ..... 1
§ 165(a) ..... 34, 1a
§ 165(b) ..... 34, 1a
§ 165(c)(2) ..... 34, 1a
§ 165(g)(1) .....9, 33, 34, 35, 1a
§ 165(g)(2)(A) ..... 34, 2a
§ 263 .....10, 25, 2a
§ 263(a) .....6, 16, 2a
§ 301(c) ..... 30
§ 302 .....1, 9, 31, 2a
§ 302(a) ..... 30, 2a
§ 302(b) ..... 30, 2a
§ 302(b)(2) .....19, 30, 3a
§ 302(b)(2)(B) ..... 30, 3a
§ 302(b)(3) .....19, 30, 4a
§ 302(c)(1) ..... 30, 5a
§ 302(d) ..... 30, 5a
§ 317(b) ..... 29
§ 318(a)(1)(A)(i) ..... 30
§ 1001(a) ..... 21
§ 1016(a)(1) .....1, 11, 5a
§ 1211 ..... 33, 34
Tax Reform Act of 1969, Pub. L. No. 91-172, § 321(a), 83 Stat. 588 ..... 26

Statutes and regulations—Continued: Page

Tax Reform Act of 1986, Pub. L. No. 99-514 (Oct. 22, 1986):
§ 301 ..... 34
§ 311 ..... 34
Treas. Reg. (26 C.F.R.):
§ 1.61-12(a) ..... 6, 11, 17, 22, 25
§ 1.83-6(d) ..... 27
§ 1.118-1 ..... 11
§ 1.165-1(b) ..... 7, 15
§ 1.263(a)-2(f) ..... 6, 10
§ 1.302-2(c) ..... 30
§ 1.1012-1(c)(1) ..... 21

Miscellaneous:

Arlinghaus, *Tax Court Questions Validity of Restricted Property Regulations*, 59 Taxes 261 (1981) ..... 31

1 B. Bittker, *Federal Taxation of Income, Estates & Gifts* (1981) ..... 12, 14

B. Bittker & J. Eustice, *Federal Income Taxation of Corporations & Shareholders* (4th ed. 1979) ..... 14, 34

Bolding, *Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss?*, 32 Tax Law. 275 (1979) ..... 24

Brodsky & Pincus, *The Case of the Reappearing Basis*, 34 Taxes 675 (1956) ..... 30

Comment, Frantz v. Commissioner, *Non Pro Rata Surrender of Stock to the Issuing Corporation*, 38 Tax Law. 739 (1985) ..... 33

Gebhardt, *When Are Loss Deductions Available on the Voluntary Surrender of Stock?*, 43 J. Tax. 22 (1975) ... 35, 36

2 H.R. Conf. Rep. 99-841, 99th Cong., 2d Sess. (1986) ... 34

H.R. Rep. 1860, 75th Cong., 3d Sess. (1938) ..... 33

H.R. Rep. 91-413, 91st Cong., 1st Sess. (1969) ..... 26

Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 Va. Tax Rev. 81 (1983) ..... 4, 14, 18, 23, 25, 33

G. Johnson & J. Gentry, *Finney and Miller's Principles of Accounting* (7th ed. 1974) ..... 23, 24, 25

10 J. Mertens, *Law of Federal Income Taxation* (1984) ... 11, 13

S. Rep. 91-552, 91st Cong., 1st Sess. (1969) ..... 8, 26, 27

# In the Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-511

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

## BRIEF FOR THE PETITIONER

### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-20a) is reported at 789 F.2d 427. The opinion of the Tax Court (Pet. App. 23a-33a) is unofficially reported at 48 T.C.M. (CCH) 786.

### JURISDICTION

The judgment of the court of appeals (Pet. App. 21a-22a) was entered on April 30, 1986. On July 18, 1986, Justice O'Connor extended the time for filing a petition for a writ of certiorari to and including September 27, 1986. The petition was filed on September 26, 1986, and was granted on November 17, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### STATUTE INVOLVED

The relevant portions of Sections 165, 302 and 1016(a)(1) of the Internal Revenue Code (26 U.S.C.) are set out in a statutory appendix (App., *infra*, 1a-5a).

## STATEMENT

1. Respondents Peter and Karla Fink, who are husband and wife, were the principal shareholders of Travco Corporation (Pet. App. 2a). Travco had one class of common stock outstanding, of which Peter owned 52.2% and Karla owned 20.3% (*id.* at 27a, 30a). Most of the rest of the stock was owned by other family members (*id.* at 30a).[1] When Travco encountered financial difficulties in the mid-1970s (*id.* at 25a-27a), respondents voluntarily surrendered a portion of their shares to the corporation. Specifically, Peter surrendered 116,146 of his 802,300 shares in 1976, and Karla surrendered 80,000 of her 311,359 shares in 1977. No other shareholder surrendered any shares (*id.* at 28a-30a). By virtue of these stock surrenders, respondents reduced their combined interest in the corporation from 72.5% of the outstanding shares to 68.5% (*id.* at 30a, 32a).

The purpose of respondents' voluntary stock surrender was "to improve Travco's financial position, to preserve its business, and to increase [its] attractiveness * * * to outside investors" (Pet. App. 3a, 28a).[2] For federal income tax purposes, respondents claimed the entire amount of their cost or "basis" in the surrendered shares—$197,782 for Peter and $191,258 for Karla—as ordinary loss deductions on their 1976 and 1977 joint tax returns (*id.* at 3a-4a).

---

[1] Peter's sister owned a 10% interest, his brother-in-law owned a 4.1% interest, and his mother owned a 2.2% interest (Pet. App. 30a).

[2] The business purpose asserted for the surrender was to make Travco more attractive to a new investor who (it was hoped) would inject new capital into the company through the purchase of a substantial quantity of new stock (see Pet. App. 28a-29a). No such new investor appeared and, some two months after Karla surrendered her stock, Peter, Karla, and Peter's mother subscribed to 700,000 new shares themselves (*id.* at 31a).



2. The Commissioner disallowed the claimed deductions. He determined that respondents' surrenders of stock to their corporation did not generate currently deductible losses, but rather constituted contributions to the corporation's capital (Pet. App. 32a). He accordingly determined deficiencies of $131,885 for 1976 and $133,826 for 1977 (*id.* at 23a).

Respondents sought redetermination of the deficiencies in the Tax Court. That court sustained the Commissioner's position (Pet. App. 23a-33a), relying on its reviewed decision in *Frantz* v. *Commissioner*, 83 T.C. 162, 174-182 (1984), aff'd, 784 F. 2d 119 (2d Cir. 1986), petition for cert. pending, No. 86-11, which was decided the same day. In *Frantz*, the Tax Court held that a stockholder's non-pro-rata surrender of shares to his corporation does not entitle him to deduct his basis in those shares as an immediate loss. The *Frantz* court held, rather, that the taxpayer's basis in the surrendered shares must be added to his basis in the shares he retains. The court explained (83 T.C. at 181) that "[t]his conclusion * * * necessarily follows from a recognition of the purpose of the transfer, that is, to bolster the financial position of [the corporation] and, hence, to protect and make more valuable [the stockholder's] retained shares." Because the stockholder in surrendering his shares was "attempting to decrease or avoid a loss on his overall investment," the Tax Court was "unable to conclude that [he] sustained a loss at the time of the transaction." Instead, the court reasoned, "[w]hether [the shareholder] would sustain a loss, and if so, the amount thereof, could only be determined when he subsequently disposed of the stock that the surrender was intended to protect and make more valuable" (*ibid.*).

The Tax Court in *Frantz* acknowledged that some of its prior opinions lent support to the taxpayers' position on the stock-surrender issue. 83 T.C. at 174-178.[3] But the

---

[3] See, *e.g.*, *Tilford* v. *Commissioner*, 75 T.C. 134 (1980), rev'd, 705 F.2d 828 (6th Cir.), cert. denied, 464 U.S. 992 (1983); *Smith* v. *Com-*

court decided that these prior opinions were "incorrect as a technical matter" and that they had the undesirable tendency "to encourage a conversion of eventual capital losses into immediate ordinary losses" (*id.* at 182). The court concluded that "[t]o perpetuate [this] line of authority * * * seems particularly inappropriate when we consider its possible ramifications on the tax system as whole," stating that the decisions in question were "expressly overruled" (*ibid.*). The *Frantz* court accordingly held that a sharenolder's non-pro-rata surrender of stock to his corporation is to be treated as a nondeductible contribution to the corporation's capital (*id.* at 181-182).

Applying the holding of *Frantz* to the facts of the instant case, the Tax Court held that respondents' stock surrenders did not give rise to immediately deductible losses (Pet. App. 32a-33a). The court therefore sustained the Commissioner's determination of deficiencies in the amount of $131,885 for 1976 and $133,826 for 1977 (*id.* at 23a, 33a).

3. A divided court of appeals reversed (Pet. App. 1a-20a). According to the majority, the outcome depended on whether a "unitary" or a "fragmented" view of stock ownership provided the proper framework for analyzing stock transactions (see *id.* at 4a-10a). Under the so-called "fragmented" view, "each share of stock is considered a

---

*missioner*, 66 T.C. 622, 628 (1976), rev'd *sub nom. Schleppy* v. *Commissioner*, 601 F.2d 196 (5th Cir. 1979); *Downer* v. *Commissioner*, 48 T.C. 86, 91 (1967). Although the Tax Court's early decisions on the subject had reflected considerable uncertainty and inconsistency about the correct way to treat these transactions (see, *e.g.*, *Ames* v. *Commissioner*, 14 B.T.A. 1067, 1072 (1929), aff'd, 49 F.2d 853 (8th Cir. 1931); *Wright* v. *Commissioner*, 18 B.T.A. 471, 473 (1929) (Murdock, J., dissenting), modified, 47 F.2d 871 (7th Cir. 1931)), the weight of the Tax Court's more recent authority was that a non-pro-rata stock surrender gives rise to an immediate loss. See generally Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 Va. Tax Rev. 81, 84-86 & nn. 18, 22 (1983).



separate investment," and gain or loss is computed separately on the sale or disposition of each share (*id.* at 5a). Under the so-called "unitary" theory, "the stockholder's entire investment is viewed as a single indivisible property unit," with the result that a sale or disposition of a portion of his shares can produce an ascertainable loss only "when the stockholder has disposed of his remaining shares" (*id.* at 5a, 12a (original quotation marks omitted)). The majority concluded that affirmance of the Tax Court would have required it to forsake the "fragmented" view of stock ownership, and it declined to do so. It noted that each share of stock is normally treated as a separate unit for tax purposes, and it held that the particular situation involved here—a majority shareholder's non-pro-rata surrender of a small portion of his shares—presented "[in]sufficient justification for abandoning the 'fragmented view' " (*id.* at 11a (emphasis deleted)).

The majority therefore concluded that respondents' stock surrender gave rise to an immediate tax loss. It remanded the case to the Tax Court for a computation of the amount of that loss, stating that the trier of fact was to make "a determination of whether [respondents'] -surrender of the stock * * * resulted in an increase in the value of their remaining shares" (Pet. App. 16a). The court of appeals stated that, "[b]arring such a finding, taxpayers are entitled to an ordinary loss deduction for the full amount of their basis in the surrendered shares" (*ibid.*).

Judge Joiner dissented (Pet. App. 17a-20a). He argued that the Second Circuit in *Frantz* v. *Commissioner*, *supra*, and the Fifth Circuit in *Schleppy* v. *Commissioner*, 601 F.2d 196 (1979), had correctly held that similar stock surrenders did not give rise to an immediate loss deduction. Judge Joiner pointed out that where, as here, "the taxpayers' sole motivation in disposing of certain shares is to benefit the other shares they hold," the majority's in-

sistence upon "[v]iewing the surrender of each share as the termination of an individual investment ignores the very reason for the surrender" (*id.* at 20a). He emphasized that respondents had "reduced their corporate ownership only slightly * * * and [had] maintained their corporate control," so that they remained after the stock surrender "in substantially the same position that they previously held [and had] not suffered any sort of meaningful loss" (*id.* at 18a). "Particularly in cases * * * where the diminution in the shareholder's corporate control and equity interest is so minute as to be illusory," Judge Joiner reasoned, "the stock surrender should be regarded as a contribution to capital" (*id.* at 20a). He accordingly concluded that, "[w]hatever validity the 'fragmented view' may have outside of the present context, it should not be applied here" (*id.* at 19a).

## SUMMARY OF ARGUMENT

A. 1. It is well established that a shareholder's transfer of cash or other property to his corporation is treated not as a loss, but as a contribution to capital. See Internal Revenue Code § 263(a) (the Code or I.R.C.); Treas. Reg. §§ 1.61-12(a) and 1.263(a)-2(f) (26 C.F.R.). This rule reflects the general proposition, recognized by this Court in *Deputy* v. *du Pont,* 308 U.S. 488 (1940), that a shareholder may not take a deduction for outlays made to benefit his corporation. Such contributions to capital result not in an immediate tax deduction, but rather in an upward adjustment to the "basis" of the stockholder's shares by the amount of his "basis" in the debt or other property transferred. The rationale for this treatment is that the purpose of the shareholder's transfer is to enhance the value of his equity investment in the corporation; because he has made a capital outlay intended to achieve long-term benefits, he may not deduct that outlay as an immediate expense or loss. There is no reason to deviate from this well-settled rule where, as here, the property



contributed to the corporation takes the form of shares of its stock.

A non-pro-rata stock surrender lacks the attributes normally associated with a "loss." It is not a permanent and absolute parting with something of value; rather, it is a deliberate expenditure taken for the purpose of improving the corporation's financial position and ultimately producing a benefit to the contributing shareholder. Moreover, the fact that the stock surrender is designed to aid the corporation and thereby enhance the value of the stockholder's remaining shares demonstrates that it is an "open" transaction that cannot yet give rise to a deductible loss. See Treas. Reg. § 1.165-1(b). Whether or not the surrender will ultimately result in a loss depends upon the extent to which the surrender succeeds in achieving its goal of enhancing the fortunes of the corporation and the value of the stockholder's investment. That cannot be determined until the transaction is "closed" by the disposition of the shareholder's remaining shares. In short, a stock surrender is a prototypical contribution to capital and should be subject to the standard tax treatment that such contributions receive: an increase in the basis of the stockholder's shares without the recognition of any immediate loss.

2. The court of appeals erred in asserting that contribution-to-capital treatment of a stock surrender is inconsistent with the so-called "fragmented" view of stock ownership that governs sales or exchanges of stock. The general principle is that shares of stock are treated just like other forms of property. When shares are sold or exchanged, gain or loss is recognized on the transaction measured by the difference between the basis of the stock sold and the amount realized upon the sale. Similarly, when shares are contributed to a corporation's capital, an adjustment to the basis of the shareholder's remaining stock should be made and no loss should be recognized,

just as if any other form of property had been contributed to the corporation's capital.

For example, if a shareholder surrenders some of the bonds that he holds, it is clear that the transaction would be treated as a capital contribution and not as a loss. That result obviously does not undermine what the court of appeals would term the "fragmented" view of bond ownership—namely, the rule that the sale or exchange of bonds is a taxable event even if the bondholder continues to hold other bonds of the same debtor. The critical distinction that determines whether a loss is immediately recognized is whether the transaction is a contribution to capital or a sale or exchange, not whether the property contributed is stock or something else.

2. Congress's enactment of Section 83(h) in 1969 confirms that contribution-to-capital treatment of stock surrenders is consistent with the structure of the Code. Section 83(h) provides that a shareholder's "bargain sale" of stock to a corporate employee as part of the latter's compensation gives rise to a corporate business deduction. The theory of this treatment is that the transfer is in reality a two-step transaction—a contribution by the shareholder of stock to the corporation, followed by the corporation's payment of that stock to the employee as compensation. See S. Rep. 91-552, 91st Cong., 1st Sess. 123-124 (1969). This congressional determination is an unequivocal rejection of the notion that the "fragmented" view of securities ownership that governs sales and exchanges prevents a stock surrender from being treated as a nondeductible capital expenditure. See *Tilford* v. *Commissioner,* 705 F.2d 828, 829 (6th Cir.), cert. denied, 464 U.S. 992 (1983).

B. 1. Established principles regarding the tax treatment of stock redemptions further confirm that respondents' stock surrender should not generate an immediately deductible loss. A redemption of shares of stock is treated as a "sale or exchange" only if it yields a "meaningful"



reduction in the shareholder's equity interest in the corporation. *United States* v. *Davis,* 397 U.S. 301, 313 (1970); I.R.C. § 302. Absent such a substantial reduction, the redemption is broken down into two parts for tax purposes. The receipt of cash is generally treated as a dividend. The surrender of shares results in no immediate gain or loss, but rather in an upward adjustment to the basis of the remaining shares—*i.e.,* it is viewed independently as a contribution to capital.

The instant stock surrender reduced respondents' interest in their corporation by an insubstantial amount—from 72.5% to 68.5%. Thus, if respondents had received even one penny a share for their surrendered stock, the surrender would have been classified as a redemption, and Section 302 would have precluded their recognition of a loss. Clearly, respondents should not receive the radically different tax treatment of an immediate loss deduction just because they elected to forgo a miniscule amount of consideration.

2. If the loss deduction supposedly generated by a stock surrender is an "ordinary" rather than a "capital" loss, as the court of appeals apparently thought (see Pet. App. 16a), the decision below opens the door for the use of stock surrenders as a tax planning device that would frustrate Congress's intent in enacting Section 165(g)(1) of the Code. That Section specifically provides that the loss incurred when a share of stock becomes worthless is a capital loss. Under the reasoning of the court below, shareholders of a failing corporation would be able to evade the effect of this provision by surrendering their stock just before it became worthless, thereby generating an ordinary loss deduction in the same amount that Section 165(g)(1) would have prescribed as a capital loss. Thus, the interplay of stock surrender treatment with other provisions of the Code makes it clear that such surrenders must be treated as nondeductible contributions to capital.

## ARGUMENT

### RESPONDENTS' SURRENDER OF STOCK TO THEIR CORPORATION IN ORDER TO IMPROVE THE CORPORATION'S FINANCIAL CONDITION DOES NOT GIVE RISE TO AN IMMEDIATELY DEDUCTIBLE LOSS

The court of appeals has held that a shareholder's non-pro-rata surrender of stock entitles him to an immediate loss deduction. This holding is at odds with fundamental and well-established principles concerning the tax treatment of shareholder contributions to their corporations. The court of appeals' holding, moreover, creates disharmony in the Internal Revenue Code by according substantially similar transactions—stock "surrenders" and stock "redemptions"—highly disparate tax treatment. Taken in conjunction with other provisions of the Code, the decision below would permit individuals to use stock surrenders as a planning tool to obtain unjustified tax benefits—approximately $265,000 in this case—by engaging in transactions that give rise to no genuine "loss" and that have little, if any, practical economic effect.

#### A. A Shareholder's Transfer Of Property To His Corporation, Whether The Property Consists Of Stock Or Of Other Assets, Is A Contribution To Capital That Does Not Give Rise To An Immediate Deduction

1. It has long been established that transfers by a shareholder to his corporation are not treated as losses, but as contributions to capital that have no immediate tax consequences. Section 263 of the Code generally provides that "capital expenditures" are not deductible. The Treasury Regulations state that "voluntary contributions by shareholders to the capital of the corporation for any corporate purpose" are regarded as "capital investments and are not deductible." Treas. Reg. § 1.263(a)-2(f). More specifically, the Regulations provide that "if a shareholder in a corporation which is indebted to him gratuitously forgives the



debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt." Treas. Reg. § 1.61-12(a). This latter provision dates back to regulations issued under the Revenue Act of 1918. See *Commissioner* v. *Auto Strop Safety Razor Co.*, 74 F.2d 226 (2d Cir. 1934).

Pursuant to Section 1016(a)(1) of the Code, a shareholder's contribution to the capital of his corporation produces an increase in the basis of his shares in an amount equal to his basis in the debt or other property transferred. See, *e.g.*, *Betson* v. *Commissioner*, 802 F.2d 365, 368 (9th Cir. 1986); *Perlman* v. *Commissioner*, 252 F.2d 890 (2d Cir. 1958), aff'g 27 T.C. 755 (1957); *Bratton* v. *Commissioner*, 217 F.2d 486 (6th Cir. 1954). By virtue of this adjustment to basis, the taxpayer will eventually "recover" his investment for tax purposes when he disposes of his shares in an arm's-length sale or exchange. This recovery of capital typically will take the form of a smaller taxable gain, or a larger deductible loss, at that future time.[4]

These well-established principles governing the transfer of property by a shareholder to his corporation reflect the general proposition, recognized by this Court in *Deputy* v. *du Pont*, 308 U.S. 488 (1940), that a shareholder may not take a deduction for an outlay made to benefit his corporation. In *du Pont*, the taxpayer incurred certain ex-

---

[4] The corollary of the principle that capital contributions are not immediately deductible by the shareholder is that such contributions are not taxable as income to the corporation. See I.R.C. § 118; Treas. Reg. § 1.118-1; 10 J. Mertens, *Law of Federal Income Taxation* § 38.22, at 50 (1984). The term "capital contribution," of course, does not presuppose on the shareholder's part "a donative intent, in the sense that there must be no business motive for making it." *Id.* at 52. To the contrary, capital contributions are ordinarily made (as they were made in the instant case, see Pet. App. 3a, 28a) for the purpose of improving the fortunes of the corporation, and hence are intended to redound to the long-term best interests of the contributing shareholder.

penses in connection with the transfer of some of his stockholdings to new executives of the corporation. The transaction was undertaken because, "[f]or business reasons, [the corporation] thought it desirable that these men have a financial interest in the company" (308 U.S. at 490). The Court held that these expenses, because they were intended to further the corporation's business, did not give rise to a deduction for the taxpayer individually. And this was so even though the taxpayer, by virtue of his stock investment in the company, hoped to derive some indirect benefit from his outlay in the form of improved (and hence more profitable) corporate performance. See *id.* at 494; see also *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590 (1943).

As Professor Bittker has explained, the payments that the shareholder sought to deduct in *du Pont* are most logically viewed as "expenditures to conserve and enhance the value of [the] taxpayer's stock." 1 B. Bittker, *Federal Taxation of Income, Estates & Gifts* ¶ 20.1.4, at 20-12 (1981) (footnote omitted). Those expenditures therefore "resembled nondeductible capital outlays to achieve long-term benefits, rather than currently deductible expenses of carrying on business" (*ibid.*). It necessarily follows from *du Pont* that transfers made to third parties for the benefit of one's corporation, like direct transfers to the corporation itself, result in an increase in the basis of one's shares, not in an immediate tax deduction. See *Rittenberg* v. *United States,* 267 F.2d 605 (5th Cir. 1959), cert. denied, 361 U.S. 931 (1960) (shareholder's payment of rent to owners of land on which his corporation had constructed a building); *South American Gold & Platinum Co.* v. *Commissioner,* 8 T.C. 1297, 1301 (1947), aff'd, 168 F.2d 71 (2d Cir. 1948) (shareholder's payment of legal fees to settle litigation against his corporation); *Eskimo Pie Corp.* v. *Commissioner,* 4 T.C. 669 (1945), aff'd, 153 F.2d 301 (3d Cir. 1946); *Koree* v. *Commissioner,* 40 T.C. 961, 965 (1963); *Ihrig* v. *Commissioner,* 26 T.C. 73 (1956). And



this result follows whether the transfer of property is pro-rata or non-pro-rata as between the taxpayer and his fellow shareholders. Indeed, it is "well settled that a contribution to capital need not be proportionate to the stockholdings of the contributor." 10 J. Mertens, *supra,* § 38.22, at 50. See, *e.g., Perlman* v. *Commissioner,* 252 F.2d at 892; *Sackstein* v. *Commissioner,* 14 T.C. 566, 569 (1950).

2. The principles just outlined establish the general rule that a shareholder's voluntary transfer of property to his corporation, or his transfer of property to a third party for the benefit of his corporation, represents a nondeductible capital contribution. This general rule applies to transfers not only of cash or tangible property but also of securities, including debt of the shareholder's corporation or stock of another corporation. The question here is whether this general rule is wholly inapplicable when the property transferred is stock of the shareholder's corporation. The court of appeals held that the general rule does not apply in such circumstances, and that a non-pro-rata stock surrender[5] represents not a capital contribution but a currently deductible "loss." But whether one analyzes the situation from a practical, common-sense perspective or from a technical viewpoint, it is clear that a stock surrender of the sort made by respondents does not give rise to a "loss."

First, the concept of a "loss" generally connotes a permanent and absolute parting with something of value. In the typical situation where a loss occurs—for example, a casualty loss, a theft loss, or a loss on the sale of property for less than one paid for it—the amount that is claimed as

---

[5] Everyone of course agrees that a pro-rata stock surrender, which leaves all shareholders owning the same percentage of the corporation that they previously owned, is not an event for loss recognition. *Frantz* v. *Commissioner,* 784 F.2d 119, 123 n.3 (2d Cir. 1986), petition for cert. pending, No. 86-11. See *Eisner* v. *Macomber,* 252 U.S. 189 (1920).

a loss by the taxpayer is a function of market conditions or other factors over which the taxpayer lacks control. The fact that he realizes less than his basis, or nothing at all, upon disposition of the property is essentially unavoidable.

Here, by contrast, the event that respondents seek to characterize as a loss was a voluntary parting with something of value in which respondents intentionally chose not to receive fair market value in return. Respondents' decision to forgo any immediate return consideration was made in the hope of realizing a more substantial ultimate return on their overall equity investment. Such a transaction is more in the nature of a deliberate "expenditure," like an investment or gift, than a "loss." See *Transport Mfg. & Equipment Co.* v. *Commissioner,* 27 T.C.M. (CCH) 924 (1968), aff'd, 431 F.2d 729 (8th Cir. 1970) (below-market sale to related corporation should be treated as a contribution to the capital of the purchasing corporation that does not give rise to a loss on the part of the seller); see also *Mack* v. *Commissioner,* 45 B.T.A. 602 (1941), aff'd, 129 F.2d 598 (2d Cir. 1942); *Evans* v. *Rothensies,* 114 F.2d 958, 961-962 (3d Cir. 1940); *Hoile* v. *Commissioner,* 4 T.C.M. (CCH) 247, 253-254 (1945); see generally Johnson, *Tax Models for Nonprorata Shareholder Contributions,* 3 Va. Tax Rev. 81, 106-107 (1983); 1 B. Bittker, *Federal Taxation of Income, Estates & Gifts* ¶ 25.3, at 25-7 to 25-8 (1981). Thus, transactions like the stock surrender here fall within the general rule that "[i]f the contribution [to the corporation] is voluntary, it does not produce gain or loss to the shareholder," but rather is treated as a contribution of capital in the amount of the contributed property. B. Bittker & J. Eustice, *Federal Income Taxation of Corporations & Shareholders* ¶ 3.14, at 3-59 (4th ed. 1979).

Secondly, and more importantly, it is clear that a "loss," in order to be deductible, must be "evidenced by closed



and completed transactions, fixed by identifiable events, and * * * actually sustained during the taxable year." Treas. Reg. § 1.165-1(b); *Boehm* v. *Commissioner,* 326 U.S. 287, 291-292 (1945). These requirements plainly are not satisfied in this case. As the Second Circuit and the Tax Court explained in *Frantz* (see 784 F.2d at 123-124; 83 T.C. at 179-181), a non-pro-rata surrender by the dominant shareholder, like the one involved here, is in reality an "open transaction." The fact that the shareholder's surrender of stock is intended to improve the financial position of his corporation—and hence to enhance the value of his remaining shares—means that the surrender itself does not result in any genuine and immediate loss to him. Whether or not the surrender will result in a loss depends upon the extent to which the shareholder ultimately succeeds in his objective of preserving the value of his stockholding.

The ultimate success of the shareholder's endeavor, of course, can be determined only when the transaction is "closed" by the disposition of his remaining shares. See *Lidgerwood Manufacturing Co.* v. *Commissioner,* 229 F.2d 241, 243 (2d Cir. 1956). If his investment decision to surrender his stock turns out to be a bad one and the entire transaction turns out to be a loss, the shareholder will receive full recognition of that loss for tax purposes when the shares are sold. On the other hand, if the investment decision turns out to be a good one, there will be no ultimate loss as a result of the surrender; the taxpayer will again receive the appropriate tax treatment (in the form of an increased basis and hence a lower capital gain) upon the closing of the transaction by the disposition of the remaining shares.

In the case of any stock surrender, it is impossible to tell whether the shareholder's effort to improve his company's financial condition will succeed—and hence whether the surrender has yielded a genuine economic loss—until he sells the shares whose value the surrender was designed to

enhance. Regardless of the ultimate outcome, therefore, the correct tax treatment is not to regard the stock surrender as an immediate loss. Rather, the correct tax treatment is that described by the Second Circuit in *Perlman* v. *Commissioner,* 252 F.2d at 892 (quoting 27 T.C. at 758): " '[The contribution] increased the basis of [the taxpayer's remaining] stock, and he will obtain tax benefit therefrom when he subsequently sells or otherwise disposes of his stock in a taxable transaction.' " See also *Whitney* v. *Commissioner,* 8 T.C. 1016, 1035-1036 (1947), aff'd on this issue, 169 F.2d 562, 569 (2d Cir.), cert. denied, 335 U.S. 892 (1948) (denying shareholders a loss deduction for their contribution of depreciated securities because there was no "closed transaction giving rise to gain or loss"); *Kistler* v. *Burnet,* 58 F.2d 687, 689 (D.C. Cir. 1932) (explaining that the tax consequences of a partial surrender will be assessed upon disposition of remaining shares).

It is of course true that a voluntary stock surrender, while intended to preserve the long-term value of the shareholder's investment, might be called a "loss" in a colloquial sense, since the shareholder has parted with a particular asset that he previously owned. But this is not the sort of "loss" that can be recognized for tax purposes, for it is precisely the sort of "loss" that occurs whenever a shareholder contributes capital (such as cash or property) to his corporation. The effect of *any* capital contribution, whether of cash, property, debt, or stock, is to reduce the contributing shareholder's net worth, and at the same time to benefit the corporation as a whole (directly) and the corporation's other shareholders (indirectly). If the reduction in the contributing shareholder's net worth occasioned by the classic capital expenditure does not give rise to an immediate loss—and the Code explicitly provides (I.R.C. § 263(a)) that it does not—there is no reason why a contribution in the form of stock should produce the opposite result. In each situation, the shareholder has acted with the investment purpose of helping his corporation,



and in each situation the reduction in his net worth should be treated as a contribution to capital and not as a loss.[6]

For these reasons, it seems manifest that the court of appeals erred in holding that respondents' surrender of their stock was a "loss," rather than a nondeductible contribution to Travco's capital. Respondents' stock surrender falls into the prototypical mold of a capital expenditure—the contribution of a portion of the shareholder's property (here, stock) for the purpose of improving the company's financial condition and thereby enhancing the value of the remainder of the shareholder's investment in it. Logically,

---

[6] As respondents (Br. in Opp. 9) and the court of appeals (Pet. App. 15a) point out, one effect of a non-pro-rata stock surrender is to reduce the shareholder's proportionate interest in the company, which can have such future effects as a reduction in dividends or voting power. Practically speaking, of course, these future effects are likely to be marginal where (as here) a controlling shareholder surrenders a small portion of his shares to a corporation in financial difficulties. A slight diminution in voting power is usually immaterial to a shareholder who continues to hold a controlling stock interest. Corporations in financial difficulties, moreover, generally do not pay dividends, and they are likely to resume paying dividends only if the business recovers, in which case the stock surrender may well turn out to have yielded the contributor an ultimate gain rather than a loss. In any event, even if a prospective reduction of dividends or voting power did constitute a real economic detriment, such future effects would not represent a currently deductible "loss." To the extent that the stock surrender ultimately proves to have an adverse economic impact upon the shareholder (for example, in the form of reduced dividends or a reduced share of corporate assets upon dissolution (see Br. in Opp. 9)), the tax consequences will be recognized at the time of the events (such as sale of the stock or liquidation of the corporation) that "close" the transaction. After all, a shareholder who surrenders *debt* to his corporation may cite numerous adverse future effects, such as loss of interest, loss of principal, and loss of potential voting power in the event of insolvency or bankruptcy. Yet it is clear beyond peradventure that a surrender of debt represents a capital contribution and does not generate a current tax deduction. See Treas. Reg. § 1.61-12(a); pages 10-11, *supra.*

such a contribution should have the effect of increasing the shareholder's basis in his remaining shares and should not give rise to an immediate tax deduction. See generally Johnson, *Tax Models for Nonprorata Shareholder Contributions,* 3 Va. Tax Rev. 81 (1983).

3. Apart from the court of appeals below, every court of appeals that has considered the question has held that non-pro-rata stock surrenders do not give rise to an immediate loss, a conclusion that accords with current controlling precedent in the Tax Court. In *Frantz* v. *Commissioner,* 784 F.2d 119 (1986), petition for cert. pending, No. 86-11, the Second Circuit held that a dominant shareholder's surrender of his preferred stock to improve the corporation's financial condition "was properly treated by the Tax Court as a contribution to the capital of [the corporation], as it had expressly been labeled by the parties at the time of the surrender" (784 F.2d at 125-126). The court noted the general rule that "[p]ayments made to further ongoing investments are not normally considered losses, but rather [are] capital expenditures" (*id.* at 123), and the court found no reason to depart from this rule where the shareholder's payment takes the form of stock. The court explained that "it is questionable whether a controlling stockholder who voluntarily surrenders stock to his corporation for the purpose of strengthening it but continues his control through stock retained by him, thereby benefiting from the surrender, necessarily suffers any recognizable loss at the time of the surrender" (*id.* at 125). Because the change in the taxpayer's interest in the corporation as a result of the surrender "was miniscule compared with [his] retained interest in the company," the Second Circuit concluded that the surrender should not be treated as giving rise to an immediate loss but rather should be regarded "as a non-deductible capital expenditure" (*ibid.*).

The Fifth Circuit in *Schleppy* v. *Commissioner,* 601 F.2d 196 (1979), similarly held that a controlling shareholder's "surrender of a very small part of [his] stockholdings * * * to the corporation itself to improve its financial position" did not give rise to a currently deductible loss (601 F.2d at 199). Speaking for a unanimous court, Judge Tuttle noted "the general proposition that voluntary payments by a stockholder to his corporation in order to bolster its financial position cannot be claimed as a loss," but rather must be "added to the basis of the stock in the stockholder's hands" (*id.* at 197). "It is difficult to perceive why any distinction should arise," the court continued, "if, instead of paying cash to the corporation, the shareholder surrenders part of his shares to bolster [its] financial health" (*ibid.*). The court noted that the dominant shareholders' surrender of their stock had reduced their controlling interest in the corporation only slightly—from 70.12% to 68.57%—and thus had "left them in substantially the same position that they previously held" (*id.* at 198). The court concluded that the shareholders' action could not be characterized as generating a "loss" and held that their basis in the shares surrendered "is to be added to their basis in their remaining shares" (*id.* at 198-199).



The courts in both *Schleppy* (601 F.2d at 198) and *Frantz* (784 F.2d at 125) emphasized that the stock surrenders in those cases had no appreciable impact on the taxpayer's position as the dominant shareholder in the corporation. These comments correctly recognize the difference in economic effect between a minimal reduction in a majority shareholder's ownership percentage and a reduction that causes him to lose control of the corporation—a difference that is explicitly reflected in the Code's redemption provisions. See I.R.C. § 302(b)(2) (providing "exchange" rather than "dividend" treatment where a shareholder receives a "substantially disproportionate redemption of stock" that brings his ownership percentage below 50%); I.R.C. § 302(b)(3) (providing "exchange" rather

than "dividend" treatment where a redemption completely terminates a shareholder's interest); pages 29-32, *infra*. Like *Schleppy* and *Frantz*, this case presents the typical scenario in which the stock surrender leaves the surrendering shareholders firmly in control of the corporation. Indeed, the facts of the instant case, involving a stock surrender that reduced respondents' controlling interest from 72.5% to 68.5%, are substantially identical to the facts in *Schleppy*, where the stock surrender reduced the taxpayers' controlling interest from 70.1% to 68.6%. Compare Pet. App. 30a with 601 F.2d at 198. In the words of Judge Joiner, dissenting from the decision below, "the diminution in [respondents'] corporate control and equity interest [was] so minute as to be illusory" (Pet. App. 20a).[7]

4. The court of appeals below failed to reach what we believe to be the correct result because it perceived this case as turning on a supposed distinction between the "fragmented" and "unitary" theories of stock ownership (see Pet. App. 4a-10a). The source of this erroneous perception (see *id.* at 7a, 11a, 14a-15a) is the Tax Court's analysis of these theories in *Downer* v. *Commissioner*, 48 T.C. 86, 90-91 (1967), an analysis that the Tax Court has since abandoned. See *Frantz*, 83 T.C. at 174-175, 179, 182 (explicitly overruling *Downer*). The court of appeals' method of viewing the case is seriously misconceived, and the analysis that it engenders provides no guidance whatsoever in resolving the question presented here.

It is, of course, well settled that if a person owns a piece of property and sells or exchanges it for cash or other property in an arm's-length transaction, his gain or loss on the deal is measured by the difference between his basis in the property sold or exchanged and the amount realized

[7] Because the instant stock surrender did not cause respondents to lose control of Travco, there is no need for the Court here to consider the proper tax treatment of a stock surrender that does lead to forfeiture of corporate control.



upon the sale or exchange (I.R.C. § 1001(a)). The same rule applies to stock. An individual who owns shares in a corporation may have quite different bases in the several shares, depending upon their purchase price and his mode of acquiring them. If he sells or exchanges some of the shares, his gain or loss is measured by the difference between the amount realized and the basis, or bases, of the particular shares sold or exchanged. See, *e.g.*, *Davidson* v. *Commissioner*, 305 U.S. 44 (1938); *Helvering* v. *Rankin*, 295 U.S. 123 (1935).[8] Only in very limited circumstances, such as after a corporate reorganization, will the differing bases of different blocks of stock be averaged and applied evenly to the total number of shares. See *Arrott* v. *Commissioner*, 136 F.2d 449 (3d Cir. 1943). Thus, shares of stock that are sold or exchanged are treated just like other types of property that are sold or exchanged, with gain or loss being computed by reference to their individual bases.

Our position in this case casts no doubt upon this well-settled rule, which the court of appeals would term the "fragmented" view of stock ownership. This case does not involve a sale or exchange. Rather, it involves a contribution to a corporation of property in the form of shares once issued by the corporation and now held by an individual shareholder. Just as a sale or exchange of stock is treated like the sale or exchange of other property, so, too, a surrender of stock should be treated like the surrender of other property. As explained above, a shareholder's surrender of other property—whether tangible assets, cash, or debt—is treated as a contribution to the corporation's capital that does not give rise to an immediate deduction. There is no sound justification for treating a surrender of stock any differently. Regardless of what sort of property

[8] In the absence of specific identification of shares, the Regulations provide that gains or losses are measured by assigning basis to the shares that are sold or exchanged on a first-in, first-out method. See Treas. Reg. § 1.1012-1(c)(1).

the shareholder decides to transfer to his corporation, his transfer is made for the purpose of enhancing or protecting the value of the shares he retains. The fact that the corporation (and, to some extent, his fellow shareholders) will also benefit from his transfer does not entitle him to a current tax deduction. This result does not follow from any abstract notion of "unitary" stock ownership, nor does it reflect any tension with the so-called "fragmented" theory governing sales and exchanges of stock. Rather, the difference in tax treatment governing stock surrenders and stock sales necessarily flows from (1) the significant difference between a shareholder's transfer of property to his own corporation and an arm's-length "sale or exchange," and (2) the lack of any significant difference between a shareholder's transfer of shares to his corporation and his transfer of some other form of property to it.

Our point may be illustrated by an example. There is absolutely no doubt that a shareholder's surrender of *debt* to his corporation constitutes a contribution to capital. See Treas. Reg. § 1.61-12(a). Accordingly, if a shareholder surrenders some of the debentures that he holds, it is settled that the transaction results in an adjustment of the shareholder's basis in his shares, and does not give rise to an immediate loss. As the Tax Court stated in *Thompson* v. *Commissioner,* 6 T.C. 285, 294 (1946), aff'd, 161 F.2d 185 (2d Cir. 1947), "[e]ven if it be assumed that the purpose of the [partial] surrender was to enhance the value of [the taxpayer's] remaining bonds, what he did was to make a capital investment of which the law takes cognizance when the transaction is finally closed by the disposition of his remaining interest." See also *Lidgerwood Manufacturing Co.* v. *Commissioner, supra; Boone* v. *Commissioner,* 33 T.C.M. (CCH) 663 (1974). Clearly, this rule has never been thought to undermine what the court of appeals might term the "fragmented" view of bond ownership—namely, the precept that the sale or exchange



of individual bonds is a taxable event even if the bondholder continues to hold other bonds of the same corporation. Thus, it is apparent that concern over the integrity of the "fragmented" theory of securities ownership provides no justification for the decision below. The court of appeals simply failed to appreciate the difference between a disposition of stock or bonds by means of a "capital contribution" and a disposition of them by means of a "sale or exchange." See Johnson, *Tax Models for Nonprorata Shareholder Contributions,* 3 Va. Tax Rev. 105-106 (1983).

5. The court of appeals sought to distinguish "the situation where a shareholder surrenders shares * * * from the circumstance where a shareholder gives cash or property to the corporation," reasoning that, "[w]hen cash or property is given to the corporation, [its] capital is increased by the value of the property contributed" (Pet. App. 15a). This objection is premised on a superficial, and ultimately erroneous, view of the accounting treatment of a stock surrender, a view that does not comport with the economic reality of the transaction. It is of course true that a corporation's treasury stock,[9] whether acquired by purchase, by exchange for debt, or by shareholder contribution, is not generally regarded as a corporate "asset" for financial accounting purposes, but rather is shown as an offset to shareholder's equity on the liability side of the balance sheet. G. Johnson & J. Gentry, *Finney and Miller's Principles of Accounting* 538 (7th ed. 1974). This accounting treatment flows from the fact that "[a] corporation that acquires its own stock obviously cannot acquire the basic rights inherent in stock ownership: the right to vote, the right to participate in dividend distributions, * * * and the right to receive a proportionate share of the corporation's assets in the event of liquidation" (*ibid.*).

[9] "Treasury stock is a corporation's own stock, once issued and later reacquired but not cancelled. Technically, it is still classed as issued stock, although no longer outstanding." G. Johnson & J. Gentry, *Finney and Miller's Principles of Accounting* 537 (7th ed. 1974).

Notwithstanding this technical accounting treatment, however, treasury stock is valuable property that a corporation can use for various corporate purposes. Treasury stock may be sold to obtain working capital. It may be reissued to a new shareholder or given as a bonus to the purchasers of other securities. Or it may be used to discharge the corporation's liability to its officers or employees under a profit-sharing or pension plan. See G. Johnson & J. Gentry, *supra,* at 538; Bolding, *Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss*?, 32 Tax Law. 275, 277 n.12 (1979). A corporation might often be able to achieve these objectives equally well by issuing new shares. But corporations frequently prefer to employ previously-issued treasury shares instead, not only to avoid possible restrictions imposed by their charters or state law,[10] but also to avoid diluting the equity of their existing shareholders.

When a corporation acquires treasury stock for free by shareholder contribution, rather than having to purchase it for cash in the open market, the corporation has received an obvious benefit from the shareholder. Although the stock thus acquired is not an "asset" in balance-sheet terms, it is functionally equivalent to an asset, since it may be used to acquire corporate assets or discharge corporate liabilities. A shareholder's surrender of stock to his corporation is thus reasonably regarded as a "contribution to capital" from the corporation's point of view. See *Schleppy* v. *Commissioner,* 601 F.2d at 197 n.2.[11]

---

[10] See G. Johnson & J. Gentry, *supra,* at 537 (noting that "[s]tockholders' preemptive rights do not apply to treasury stock; treasury shares may be returned to an outstanding status without stockholders' authorization; * * * and if treasury stock was fully paid when originally issued, it can be reissued at a discount without imposing any discount liability on the new owner").

[11] Although there are various methods of accounting for stock surrenders on a company's balance sheet, under one commonly-used method "donated treasury stock is recorded following the same procedures used for purchased treasury stock, except that the credit is to Donated Capital." G. Johnson & J. Gentry, *supra,* at 549.



Indeed, actions taken by shareholders to benefit their corporations are routinely treated as "contributions to capital" for tax purposes, even though they do not increase the corporation's stated capital or assets in a technical accounting sense. For example, as provided by Treas. Reg. § 1.61-12(a), a shareholder's forgiveness of a corporation's indebtedness to him "amounts to a contribution to the capital of the corporation," although neither stated capital nor assets are increased. And a shareholder's payment of an expense of his corporation is regarded as a "contribution to capital," although such payment discharges the corporation's liability rather than adding to its capital or assets. See *Rittenberg* v. *United States, supra; Koree* v. *Commissioner, supra.*

In each of these situations, what is important is not the transaction's effect on the corporation's balance sheet, but whether the transaction is a "capital expenditure" on the part of the shareholder, in which case the Code prohibits the shareholder from claiming an immediate loss deduction. As the Tax Court explained in *Ihrig* v. *Commissioner,* 26 T.C. at 76, a shareholder's expenditure "to safeguard and maintain the existence of the corporation[] so as not to jeopardize his personal interest" is an inherently capital expense. "Payments made by a stockholder of a corporation for the purpose of protecting his interest therein must be regarded as [an] additional cost of his stock," and such an expenditure cannot be currently deducted. *Eskimo Pie Corp.* v. *Commissioner,* 4 T.C. at 676. See Johnson, *Tax Models for Nonprorata Shareholder Contributions,* 3 Va. Tax Rev. 81, 127 (1983).[12]

---

[12] The court of appeals suggested that a stock surrender cannot properly be viewed as "represent[ing] an additional price paid for the

6. In 1969, Congress confirmed the correctness of our view that a stock surrender designed to advance the financial interest of the corporation does not generate an immediate loss deduction for the shareholder, but rather should be treated as a contribution to the corporation's capital. In that year, Congress added Section 83 to the Code to address the tax consequences of the transfer of restricted stock to an employee as compensation. Tax Reform Act of 1969, Pub. L. No. 91-172, § 321(a), 83 Stat. 588; H.R. Rep. 91-413, 91st Cong., 1st Sess. 86-89 (1969); S. Rep. 91-552, 91st Cong., 1st Sess. 119-124 (1969). One of the problems that arose in the drafting of this Section was to determine the correct way to treat the situation where a shareholder, rather than the corporate employer, makes a "bargain sale" of stock to an officer or employee. In *Downer* v. *Commissioner, supra,* the source of the "fragmented" theory of stock ownership on which the court of appeals below relied (see Pet. App. 7a, 11a, 14a-15a), the Tax Court had held that the shareholder could take an immediate loss deduction on such a sale. Congress in 1969 specifically declined to adopt that approach.

In Section 83(h), Congress provided that the corporation may take a business-expense deduction for the

---

stock" (Pet. App. 15a), but this statement is plainly mistaken. The effect of respondents' stock surrender was to convert their original purchase of Travco shares into a purchase of a smaller percentage of the company for the same total price. Thus, while respondents' surrender did not inject any new cash into Travco, it did cause them, retroactively as it were, to pay a higher *per share* price for the stock that they retained, and the surrender thus represented "an additional price paid for [that] stock" (*ibid.*). The tax treatment that we believe proper—namely, an increase in the cost or "basis" of respondents' retained shares in an amount equal to their cost or "basis" in the shares that they surrendered—thus comports exactly with the economic reality of the situation.



amount by which the employee is deemed to have been compensated by such a stock transfer. The Senate Finance Committee (S. Rep. 91-552, *supra,* at 123-124) explained the rationale for this treatment as follows:

> In general, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the parent company or shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the restricted property rules. The parent company or the shareholder merely is to reflect the contribution as an increase of the equity in the company which is entitled to the compensation deduction.

See also Treas. Reg. § 1.83-6(d). Congress thus recognized in Section 83(h) that a "bargain sale" from a shareholder to an employee for the benefit of the corporation should not be treated as a routine "sale or exchange." Rather, the purpose and effect of the transaction mandates that the bargain element of the stock transfer be treated as a contribution to capital by the selling shareholder, followed by the payment of compensation by the corporation to the employee. The corollary of this treatment, of course, is that the selling shareholder is not entitled to an immediate loss deduction on the bargain element of the sale.

As the Sixth Circuit observed in *Tilford* v. *Commissioner,* 705 F.2d 828, cert. denied, 464 U.S. 992 (1983), the enactment of Section 83(h) was a repudiation of the Tax Court's reasoning in *Downer.* Congress concluded that, despite what the Tax Court referred to as the "fragmented" view of stock ownership, a shareholder's transfer of stock to a corporate employee to further the purposes of the corporation should be treated as a contribution to capital that has no immediate tax consequences for the shareholder. In the words of the Sixth Circuit, the enactment of Section 83(h) reflected the "apparent intention on the part of the Congress to embrace a

theory contrary to the one underlying the *Downer* case" (705 F.2d at 829). Congress's action in 1969 thus lends strong support to our contention that the "fragmented" view of stock ownership, which governs the tax treatment of sales and exchanges, has no application where (as here) a stockholder makes a contribution to capital by transferring stock to or for the benefit of his corporation.[13]

The court below sought to limit *Tilford* to its facts (Pet. App. 15a-16a). But there is no rational basis for treating a shareholder's transfer of stock to an employee as a contribution to capital, yet failing to accord the same treatment to a shareholder's surrender of stock directly to the issuing corporation. See *Frantz* v. *Commissioner*, 83 T.C. at 178 n.15. This point may be illustrated by a simple example. Assume a corporation with 100 shares outstanding, of which X owns 80 shares and Y owns 20 shares. Assume

[13] The court of appeals suggested (Pet. App. 15a-16a) that Congress's enactment of Section 83(h) could be read to *support* its holding, on the theory that a negative inference could be drawn from Congress's decision to address shareholder transfers of stock to corporate employees, without simultaneously addressing shareholder surrenders of stock directly to the corporation. This suggestion is specious. In drafting Section 83, Congress was attempting to deal with all relevant aspects of a particular issue—transfers of restricted stock to employees as compensation. To perform this task fully, Congress was required to deal with the situation in which stock was transferred to an employee by a shareholder rather than by the corporation itself, as happened in *Downer*. Congress simply had no occasion to consider stock surrenders that are unconnected to employee compensation and that are made to the corporation rather than to its employees. The negative inference that the court of appeals sought to draw from Congress's enactment of Section 83(h) is thus illogical. As pointed out in the text, the relevant inference that should be drawn from that enactment is that Congress disapproved the reasoning of the Tax Court's decision in *Downer*, reasoning on which the court of appeals heavily and erroneously relied.



that the corporation wishes to increase Y's ownership percentage to 25%, but wishes to do so without issuing any new stock. This result could be accomplished in two ways. X could surrender 20 shares to the corporation, leaving him with 60 shares and Y with 20. Or X could transfer five shares to Y, leaving X with 75 shares and Y with 25. In either event, X will own 75% of the corporation, and Y will own 25%, after the transaction has been consummated. In enacting Section 83(h), Congress made clear that X in the latter situation should be deemed to have made a contribution to the corporation's capital, and that his basis in the transferred shares should be added to the basis of the shares he retains. There is no conceivable justification for permitting X to take an immediate loss deduction when the same end result is accomplished by the former route. Congress's action in 1969 thus confirms that, when a shareholder surrenders a portion of his stock holdings in an effort to improve the financial condition of the corporation, his transfer is properly viewed not as a loss but as a contribution to capital.

### B. Allowing A Shareholder To Claim An Immediate Loss Deduction For A Stock Surrender Creates Substantial Tension With Other Provisions Of The Code

#### 1. The Law Pertaining To Stock Redemptions Indicates That Stock Surrenders Do Not Generate An Immediate Loss

The court of appeals' approval of immediate loss treatment for respondents' non-pro-rata stock surrender cannot be reconciled with established principles regarding the tax treatment of stock redemptions. A "redemption" occurs when a shareholder surrenders stock to his corporation and receives cash or other property in return (I.R.C. § 317(b)). It is normally advantageous for the shareholder to have a redemption treated as a "sale or exchange" of his stock, in which case he will recognize an immediate capital gain or loss. "Sale or exchange" treatment is accorded to the shareholder, however, only if the redemption yields a

substantial, or "meaningful," reduction in his percentage interest in the corporation. *United States* v. *Davis,* 397 U.S. 301, 313 (1970); I.R.C. § 302(a), (b) and (d).[14]

Absent a substantial reduction in the shareholder's overall interest in the corporation, a stock redemption is broken down into two parts for tax purposes, with the receipt of cash or property being dissociated from the surrender of shares. The receipt of cash or property is generally treated as a dividend. See I.R.C. § 302(d), cross-referring to I.R.C. § 301(c). The surrender of shares is viewed independently and results in no immediate gain or loss. Rather, the shareholder's basis in the surrendered shares is added to his basis in the stock retained. See *United States* v. *Davis,* 397 U.S. at 307-308 n.9; Treas. Reg. § 1.302-2(c); Brodsky & Pincus, *The Case of the Reappearing Basis,* 34 Taxes 675, 676-677 (1956). Thus, if a stock redemption fails to produce a meaningful reduction in the redeeming shareholder's ownership interest, the redemption is not treated as a "sale or exchange," but rather is treated as a contribution to capital in the form of a stock surrender, coupled with the separate payment of a cash distribution to the shareholder.

---

[14] Congress has quantified the concept of a "meaningful" reduction in a pair of safe-harbor provisions. Specifically, Section 302(b)(3) provides "sale or exchange" treatment when a redemption completely terminates a shareholder's equity interest in the corporation. And Section 302(b)(2) provides "sale or exchange" treatment when a redemption is "substantially disproportionate" with respect to the redeeming shareholder. Of particular relevance here, the latter provision requires that the redeeming shareholder own less than 50% of the corporation's voting stock immediately after the redemption in order for the redemption to be deemed "substantially disproportionate." I.R.C. § 302(b)(2)(B). Respondents together owned 68.5% of Travco's voting stock immediately after their stock surrenders (Pet. App. 32a) and, for purposes of Section 302(b), each would be deemed to own the other's stock as well as his own. See I.R.C. § 302(c)(1), cross-referring to I.R.C. § 318(a)(1)(A)(i) (providing that an individual shall be considered as owning stock owned directly or indirectly by his spouse).



In this case, respondents' surrender of shares to Travco reduced their interest in the corporation from 72.5% to 68.5%, a reduction that Judge Joiner correctly characterized as "so minute as to be illusory" (Pet. App. 20a). If respondents had received any cash in conjunction with the surrender—even one penny a share—the surrender would have been treated as a redemption subject to the provisions of Section 302. In that event, the cash would have been treated as a dividend or other distribution, and respondents' basis in the surrendered shares would have been added to their basis in the shares retained, just as if they had made a contribution to capital in an amount equal to their basis in the surrendered shares. Because respondents received no cash, their transaction did not fall within the literal terms of the redemption provisions, and Section 302 therefore does not itself mandate the tax treatment just described. But it would indeed be a perverse result if respondents could secure the radically different tax treatment of an immediately deductible loss simply by forgoing a peppercorn of consideration.

Practically speaking, a stock surrender resembles a redemption for a zero dividend. More precisely, a stock surrender is equivalent to a redemption in which the quid-pro-quo for the shareholder is not the immediate and direct benefit of a cash dividend, but rather the more indirect and long-term benefit of enhancing his overall investment in the corporation through the improvement of its financial condition. Thus, redemption principles strongly indicate that when a shareholder makes a non-pro-rata stock surrender to improve the financial position of his corporation, while maintaining the same effective control over the corporation that he had before, he has suffered no loss. See *Frantz*, 784 F.2d at 125; Arlinghaus, *Tax Court Questions Validity of Restricted Property Regulations*, 59 Taxes 261, 264-265 (1981). The tax consequences of the transaction should therefore be the same as

those that would attend a redemption of his shares, namely, the addition of the basis in the surrendered shares to the basis in the shares he retains.[15]

**2. The Decision Below May Enable A Stockholder In A Failing Corporation To Avoid The Tax Consequences Prescribed By Section 165(g) Of The Code**

The court of appeals' decision confers at least one, and perhaps two, unjustified tax benefits upon taxpayers who make non-pro-rata stock surrenders. First, the decision below permits the acceleration of tax deductions through the recognition of a currently deductible loss on a transfer that, if effected by the use of any property other than corporate stock, would result in a nondeductible contribution to the corporation's capital. This is true regardless of whether the loss is characterized as capital or ordinary. If the loss is characterized as ordinary, however, as both the court of appeals (Pet. App. 16a) and the Tax Court in *Frantz* (83 T.C. at 182) apparently assumed that it would be,[16] the decision below opens the door to a second, and

[15] It is of course true that the tax abuse at which the Code's redemption provisions were aimed (the bailout of corporate earnings to shareholders as capital gains rather than as dividends) is not the same as the tax abuse that may accompany unilateral stock surrenders (the acceleration of capital loss deductions and their possible conversion into ordinary losses). Cf. *Frantz*, 83 T.C. at 178 n.16. But that by no means suggests any inappropriateness in the redemption analogy that we have drawn in the text. The redemption provisions reflect Congress's determination (1) that a shareholder's surrender of stock to his corporation should not be treated as a "sale or exchange," and hence should not be the occasion for recognizing a loss, unless the reduction in the shareholder's ownership interest is meaningful; and (2) that a shareholder's surrender of shares, in the absence of such a meaningful reduction, should be accounted for by increasing the basis of his retained shares, just as if he had made a contribution to the corporation's capital. Both of these principles are fully applicable to the instant case and dictate its proper outcome.

[16] The issue of whether any loss realized on a stock surrender should be characterized as capital or ordinary was not briefed by the



even greater, windfall for shareholders of failing corporations. Indeed, it would lay the foundation for the use of stock surrenders as a tax planning tool by which shareholders could unjustifiably avoid the tax treatment mandated by other provisions of the Code.

Prior to 1938, the Code had provided that losses sustained when stock became worthless were treated as ordinary losses, even though the sale or exchange of such stock before it became worthless would have given rise to a capital loss. Congress recognized that this disparate treatment was "not satisfactory, since, in either case, the loss sustained by the taxpayer is a loss of capital and consequently should be treated similarly for tax purposes." H.R. Rep. 1860, 75th Cong., 3d Sess. 18 (1938). Accordingly, Congress enacted what is now Section 165(g)(1) of

parties below. The court of appeals nevertheless stated in the last sentence of its opinion that respondents would be "entitled to an ordinary loss deduction" (Pet. App. 16a). That view is supported by some older Tax Court decisions, which were overruled in *Frantz*. See *Smith* v. *Commissioner*, 66 T.C. at 648; *Budd Int'l Corp.* v. *Commissioner*, 45 B.T.A. 737, 756 (1941). See *Frantz*, 83 T.C. at 175. And characterization of the supposed loss as ordinary would derive some support from the text of Section 1211, which speaks of "losses from sales or exchanges of capital assets," since a stock surrender is not literally a "sale or exchange." See generally *Frantz*, 784 F.2d at 124. On the other hand, there is authority to support the proposition that such a loss would be capital. The Tax Court in *Downer* viewed as capital the loss supposedly realized upon a shareholder's transfer of stock to a corporate employee (48 T.C. at 92-93), and it has been suggested by commentators that this view would be preferable to treating the loss as ordinary. See Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 Va. Tax Rev. 81, 117 (1983); Comment, Frantz v. Commissioner, *Non Pro Rata Surrender of Stock to the Issuing Corporation*, 38 Tax Law. 739, 754-757 (1985). In truth, neither characterization of the loss supposedly realized on a stock surrender is wholly satisfactory. The correct resolution of the dilemma is of course to recognize that, for the reasons we have stated, a shareholder's voluntary surrender of stock does not generate *any* kind of immediately deductible loss.

the Code, which generally provides that the loss incurred when stock becomes worthless is a capital loss.[17] See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations & Shareholders* ¶ 4.09, at 4-34 (4th ed. 1979).

If the decision below is permitted to stand, and if the court of appeals is correct in stating that shareholders who surrender stock "are entitled to an ordinary loss" (Pet. App. 16a), taxpayers will easily be able to thwart Congress's purpose in enacting Section 165(g)(1). As explained by the Tax Court in *Frantz* (83 T.C. at 182), shareholders of financially distressed corporations who reasonably expect their stock to become worthless need not sit idly by and accept the capital-loss treatment mandated by Section 165(g)(1).[18] If they surrender their shares to the corporation just before the shares become worthless, they will be able to take an ordinary loss in the same amount that Sec-

[17] Section 165(g)(1) provides that "[i]f any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset." Section 165(g)(2)(A) in turn defines "security" to include "a share of stock in a corporation."

[18] The distinction between capital losses and ordinary losses retains considerable importance even though the Tax Reform Act of 1986 has eliminated the differential in tax rates as between capital gains and ordinary income. Pub. L. No. 99-514, §§ 301, 311 (Oct. 22, 1986). That is because the new Code retains the limitation, applicable under previous law, that allows individuals annually to deduct only $3,000 of net capital losses against ordinary income; that limitation also prohibits corporate taxpayers from deducting any capital losses against ordinary income. I.R.C. § 1211; see 2 H.R. Conf. Rep. 99-841, 99th Cong., 2d Sess. 105-106 (1986). Ordinary losses, by contrast, are generally deductible in full against ordinary income. I.R.C. § 165(a), (b) and (c)(2). Thus, unless a taxpayer has capital gains against which a capital loss can be offset, he typically will be able to obtain only a limited current tax benefit from the loss if it is characterized as capital rather than ordinary.



tion 165(g)(1) would have contemplated that they take a capital loss. Indeed, a blueprint for converting capital losses to ordinary losses in precisely this fashion is contained in a practitioners' article published in 1975. See Gebhardt, *When Are Loss Deductions Available on the Voluntary Surrender of Stock?*, 43 J. Tax. 22 (1975).[19]

[19] The article characterizes the stock surrender as "a viable relatively risk-free way of converting part of a shareholder's capital loss on his investment into an ordinary loss" (43 J. Tax. at 26). The article explains the scheme as follows (*id.* at 25-26 (footnote omitted)):

> The stock surrender * * * should have distinct application to tax planning with respect to corporations in failing financial health. One or more stockholders could surrender some, but not all * * *, of their shares to the corporation in disproportionate amounts; under the applicable case law they can obtain ordinary loss deductions for either their full cost basis for the surrendered shares or their cost basis for the surrendered shares less the enhancement of the book value of their remaining shares, depending on which view is applied in determining the amount of loss. Such a surrender should be procedurally accomplished by assigning and delivering the certificates to the corporation. It would also seem appropriate to accompany the certificates with a letter expressing the unconditional nature of the assignment and stating that the purpose of the assignment is to improve the corporation's financial position.
>
> * * * * *
>
> If the corporation were about to fail completely, a stock surrender to the corporation could also be used to obtain an ordinary loss deduction for a shareholder in the manner previously described. It would be necessary to make the surrender when the corporation's stock still had value, since a loss on worthless stock is capital and subject to the restrictions of Sections 1011 and 1012. It would seem hard for the Service to segregate, for purposes of disallowing the loss deduction, the desire to aid the corporation's finances and protect the retained investment from the tax planning (or tax avoidance) motive of converting an eventual capital loss into a partial ordinary loss.

Adverting to these tax-avoidance possibilities, the Second Circuit in *Frantz* held that there is no justification for treating a stock surrender as a loss. "To do so," the court explained, "would enable a taxpayer, who acts voluntarily in making the surrender, to manipulate his holdings for tax advantages that would not be available if he sold his shares without any such interlocking of his equity interests in the corporation" (784 F.2d at 125). The Tax Court likewise was not engaging in overstatement when it said that permitting a shareholder to take an ordinary loss deduction upon surrendering stock to his closely-held corporation "could encourage the practical equivalent of a judicial repeal of section 165(g)." *Frantz*, 83 T.C. at 182.[20] Thus, the interplay of stock-surrender treatment with other provisions of the Code confirms that such surrenders must be treated as nondeductible contributions to capital.

### 3. The Court of Appeals' Proposed Method Of Computing Respondents' Alleged "Loss" Is Both Unprecedented and Impractical

Although the court of appeals concluded that respondents' stock surrender entitled them to a loss deduction, the court did not hold that the amount of their deduction

[20] The Tax Court found in this case that respondents' stock surrenders had a business purpose and "were not primarily tax motivated" (Pet. App. 32a). We do not challenge that factual finding. It bears mentioning, however, that respondent Peter Fink testified that he followed the advice of tax counsel in deciding which shares to surrender (Tr. 35-36). It also bears mentioning that, when respondents surrendered their shares, they forwarded their certificates to the corporation accompanied by letters stating that they were "unconditionally surrendering" their shares and were doing so "in order to improve the financial condition of the company" (Stip. Exhs. 7-G, 8-H)—precisely as recommended in Mr. Gebhardt's blueprint for creating ordinary loss deductions, which was published just over a year before. See 43 J. Tax. at 25-26 (quoted in note 19, *supra*).



would necessarily be equal to their cost or "basis" in the stock surrendered. Rather, the court remanded "for a determination of whether the surrender of the stock by the taxpayers resulted in an increase in the value of their remaining shares" (Pet. App. 16a). The court of appeals did not elaborate on the point, but such increase in value might occur in at least two ways. First, respondents' surrender would cause the worth of the corporation to be allocated among fewer outstanding shares, so that respondents' remaining shares would have a higher value per-share than they had previously.[21] Second, respondents' stock surrender was designed to improve the corporation's financial position—by making the company more attractive to outside investors, for instance—and the surrender could thus be expected to have some difficult-to-quantify impact on the "market value" of respondents' remaining stock. The court of appeals intimated (*ibid.*) that any increase in value resulting from the surrender should be subtracted from respondents' basis in the surrendered shares in order to determine the magnitude of their supposed "loss."

If one were to accept the court of appeals' erroneous premise that a voluntary stock surrender generates a loss, the court's proposed method of computing the amount of that loss would arguably make some sense in a world of pure theory. But "[t]axation is a practical matter" (*Harrison* v. *Schaffner*, 312 U.S. 579, 582 (1941)), and the court's proposed computation would be extremely difficult

[21] This effect may be illustrated by reference to our example (pages 28-29, *supra*) concerning a hypothetical corporation with 100 outstanding shares, 80 of which are owned by X and 20 of which are owned by Y. Assume that the corporation is worth $100, so that X's 80 shares are worth $80. Assume that X then surrenders 20 shares, leaving him with 60 and Y with 20. Since the corporation is still worth at least $100 after the surrender, and since X owns 75% of the stock after the surrender, his 60 shares are now worth $75, whereas those 60 shares were worth only $60 before.

in practical terms. Closely-held family corporations are notoriously difficult to value, particularly when they are in financial distress and when factors like "enhanced attractiveness to outside investors" must be taken into account. See *Frantz*, 784 F.2d at 124. The court's proposed computation, moreover, is unprecedented—at least outside the stock-surrender arena—and is bizarre as a matter of basic tax principles. The premise of the proposed computation is that respondents have realized a loss upon surrendering their shares. But respondents obviously have not realized any gain on the shares that they have retained. We can think of no instance in which the Internal Revenue Code provides that a deduction is to be computed by offsetting a realized loss by an unrealized gain.

These computational difficulties, like the difficulties that attend the determination whether respondents' supposed "loss" should be deemed capital or ordinary (see note 16, *supra*), are not, we submit, accidental. Rather, they point up the fundamental error of the court of appeals' premise—that a stock surrender generates a "loss" of any sort. If respondents' stock surrender is held to be a capital contribution, all of these difficulties will be avoided. We urge the Court to avoid them.



## CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

CHARLES FRIED
*Solicitor General*

ROGER M. OLSEN
*Assistant Attorney General*

ALBERT G. LAUBER, JR.
*Deputy Solicitor General*

ALAN I. HOROWITZ
*Assistant to the Solicitor General*

JONATHAN S. COHEN
DAVID I. PINCUS
*Attorneys*

JANUARY 1987

## APPENDIX

**INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):**

**SEC. 165. LOSSES.**

(a) *General Rule.* – There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.* – For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on Losses of Individuals.* – In the case of an individual, the deduction under subsection (a) shall be limited to –

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100.

* * * * *

(f) *Capital Losses.* – Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) *Worthless Securities.* –

(1) *General rule.* – If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this

subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) *Security defined.*—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

* * * * *

**SEC. 263. CAPITAL EXPENDITURES.**

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

* * * * *

**SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK**

*(a) General rule*

If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

*(b) Redemptions treated as exchanges*

*(1) Redemptions not equivalent to dividends*

Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.



*(2) Substantially disproportionate redemption of stock*

*(A) In general*

Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

*(B) Limitation*

This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

*(C) Definitions*

For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time.

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

*(D) Series of redemptions*

This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

*(3) Termination of shareholder's interest*

Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

*(4) Redemption from noncorporate shareholder in partial liquidation*

Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

*(5) Application of paragraphs*

In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.



*(c) Constructive ownership of stock*

*(1) In general*

Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

* * * * *

*(d) Redemptions treated as distributions of property*

Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

**SEC. 1016. ADJUSTMENTS TO BASIS.**

(a) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, * * *.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1987—181-483/40193

# RESPONDENT'S

# BRIEF

Supreme Court, U.S.
FILED
MAR 20 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-511

# In The Supreme Court of the United States

October Term, 1986

---

Commissioner of Internal Revenue,
*Petitioner,*

v.

Peter R. Fink et ux.,
*Respondents.*

---

**On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit**

---

## BRIEF FOR RESPONDENTS

---

*Of Counsel:*
W. Merritt Jones, Jr.
Mark K. Wilson
Hill, Lewis, Adams,
Goodrich & Tait
100 Renaissance Center
Detroit, Michigan 48243

Matthew J. Zinn
(Counsel of Record)
Susan H. Serling
J. Walker Johnson
Steptoe & Johnson
1330 Connecticut Ave., N.W.
Washington, D.C. 20036
(202) 429-6422
*Attorneys for Respondents*

Wilson - Epes Printing Co., Inc. - 789-0096 - Washington, D.C. 20001

BEST AVAILABLE COPY

## QUESTION PRESENTED

Whether a shareholder's non-pro rata surrender of common stock to the issuing corporation, in order to improve the corporation's financial position and make it a more attractive investment for outsiders, gives rise to an immediately deductible loss.

TABLE OF CONTENTS


| | Page |
|---|---|
| TABLE OF AUTHORITIES | v |
| STATUTE AND REGULATIONS INVOLVED | 1 |
| STATEMENT | 1 |
| SUMMARY OF ARGUMENT | 6 |
| ARGUMENT | 11 |
| I. RESPONDENTS' NON-PRO RATA SURRENDERS OF STOCK GAVE RISE TO IMMEDIATELY DEDUCTIBLE LOSSES | 11 |
| A. Upon the Surrender of Their Stock, Respondents Actually Sustained Immediately Deductible Losses | 12 |
| B. Respondents' Non-Pro Rata Stock Surrenders Were Closed and Completed Transactions | 14 |
| C. Respondents Are Entitled to Prevail Under Either the "Fragmentary" or the "Unitary" Theory of Stock Ownership | 16 |
| II. CONTRARY TO THE GOVERNMENT'S ARGUMENTS, RESPONDENTS' NON-PRO RATA SURRENDERS OF STOCK WERE NEITHER CONTRIBUTIONS TO CAPITAL NOR ANY OTHER TYPE OF CAPITAL EXPENDITURE | 18 |
| A. Respondents' Non-Pro Rata Surrenders of Stock Were Not Contributions to Capital | 18 |
| B. Respondents' Non-Pro Rata Surrenders of Stock Were Not Otherwise Capital Expenditures | 23 |
| C. Section 83 Is Inapplicable Outside the Area of Employee Compensation | 26 |

TABLE OF CONTENTS—Continued


| | Page |
|---|---|
| III. THE GOVERNMENT'S REMAINING ARGUMENTS ARE WITHOUT MERIT | 28 |
| A. Neither Section 302 Nor Its "Principles" Guide Decision in This Case | 31 |
| B. Allowance of Immediate Loss Deductions Would Pose No Threat to Section 165(g) | 36 |
| C. The Court of Appeals' Method of Computing Respondents' Losses is Neither Unprecedented Nor Impractical | 38 |
| CONCLUSION | 39 |
| APPENDIX | 1a |




TABLE OF AUTHORITIES

CASES:


| | Page |
|---|---|
| *Beck v. Commissioner*, 8 T.C.M. (CCH) 126 (1949), *aff'd*, 179 F.2d 688 (7th Cir. 1950) | 33 |
| *Berner v. United States*, 282 F.2d 720 (Ct. Cl. 1960) | 29 |
| *Bratton v. Commissioner*, 217 F.2d 486 (6th Cir. 1954) | 19 |
| *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950) | 20 |
| *Budd Int'l Corp. v. Commissioner*, 45 B.T.A. 737 (1941), *acq.*, 1942-2 C.B. 3, *acq. withdrawn & nonacq. substituted*, 1977-1 C.B. 2, *rev'd on other grounds*, 143 F.2d 784 (3d Cir. 1944), *cert. denied*, 323 U.S. 802 (1945) | 28, 29, 38-39 |
| *Burdick v. Commissioner*, 20 B.T.A. 742 (1930), *aff'd*, 59 F.2d 395 (3d Cir. 1932) | 28, 29 |
| *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954) | 14, 37, 38 |
| *Christie v. Fifth Madison Corp.*, 211 N.Y.S.2d 787 (1961) | 21, 22 |
| *City Builders Finance Co. v. Commissioner*, 21 B.T.A. 800 (1930) | 28 |
| *Clement v. Commissioner*, 30 B.T.A. 757 (1934) | 28 |
| *Commissioner v. Groetzinger*, 55 U.S.L.W. 4175 (U.S. Feb. 24, 1987) | 12 |
| *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) | 23, 24 |
| *Commonwealth, Inc. v. Commissioner*, 36 B.T.A. 850 (1937) | 33 |
| *Crane v. Commissioner*, 331 U.S. 1 (1947) | 12 |
| *Davidson v. Commissioner*, 305 U.S. 44 (1938) | 16 |
| *Deputy v. du Pont*, 308 U.S. 488 (1940) | 24, 25, 27 |
| *Downer v. Commissioner*, 48 T.C. 86 (1967) | 28 |
| *Duell v. Commissioner*, 19 T.C.M. (CCH) 1381 (1960) | 28, 38 |
| *Eisner v. Macomber*, 252 U.S. 189 (1920) | 12, 13, 20 |
| *Eskimo Pie Corp. v. Commissioner*, 4 T.C. 669 (1945), *aff'd*, 153 F.2d 301 (3d Cir. 1946) (per curiam) | 19, 25, 26, 27 |

TABLE OF AUTHORITIES—Continued


| | Page |
|---|---|
| *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947) | 28, 29 |
| *Estate of Steckel v. Commissioner*, 26 T.C. 600 (1956), *aff'd*, 253 F.2d 267 (6th Cir. 1958) (per curiam) | 26 |
| *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979) | 38 |
| *Frantz v. Commissioner*, 83 T.C. 162 (1984), *aff'd*, 784 F.2d 119 (2d Cir. 1986), *petition for cert. pending*, No. 86-11 | 5, 17, 22, 25, 29, 34, 35 |
| *Fribourg Nav. Co. v. Commissioner*, 383 U.S. 272 (1966) | 30 |
| *Helvering v. Gowran*, 302 U.S. 238 (1937), *reh'g denied*, 302 U.S. 781 (1938) | 13 |
| *Helvering v. Rankin*, 295 U.S. 123 (1935) | 16 |
| *Helvering v. Sprouse*, 318 U.S. 604 (1943) | 13 |
| *Ihrig v. Commissioner*, 26 T.C. 73 (1956) | 19, 25 |
| *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, *reh'g denied*, 320 U.S. 809 (1943) | 24, 25 |
| *Koshland v. Helvering*, 298 U.S. 441 (1936) | 13, 15, 22 |
| *Kress v. Stanton*, 98 F. Supp. 470 (W.D. Pa. 1951), *aff'd*, 196 F.2d 499 (3d Cir. 1952) (per curiam) | 29 |
| *Lidgerwood Manufacturing Co. v. Commissioner*, 229 F.2d 241 (2d Cir.), *cert. denied*, 351 U.S. 951 (1956) | 19, 20 |
| *Mack v. Commissioner*, 45 B.T.A. 602 (1941), *aff'd*, 129 F.2d 598 (2d Cir. 1942) | 24 |
| *Malat v. Riddell*, 383 U.S. 569 (1966) | 12 |
| *Miller v. Commissioner*, 45 B.T.A. 292 (1941), *acq.*, 1941-2 C.B. 9, *acq. withdrawn & nonacq. substituted*, 1977-1 C.B. 2 | 28, 29, 38 |
| *Northwest Motor Servs. Co. v. United States*, 1960-2 U.S. Tax Cas. (CCH) ¶ 9488 (D.N.D. 1960) | 29 |
| *Payne Hous. Corp. v. Commissioner*, 13 T.C.M. (CCH) 603 (1954) | 28, 29 |
| *Peabody Coal Co. v. United States*, 8 F. Supp. 845 (Ct. Cl. 1934) | 29 |




TABLE OF AUTHORITIES—Continued


| | Page |
|---|---|
| *Perlman v. Commissioner*, 252 F.2d 890 (2d Cir. 1958), *aff'g* 27 T.C. 755 (1957) | 19, 20 |
| *Rittenberg v. United States*, 267 F.2d 605 (5th Cir. 1959), *cert. denied*, 361 U.S. 931 (1960) | 19, 25, 27 |
| *Scherman v. Helvering*, 74 F.2d 742 (2d Cir. 1935) | 13, 24, 29 |
| *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979) | 5, 25, 34 |
| *Smith v. Commissioner*, 66 T.C. 622 (1976), *rev'd sub nom. Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979) | 5, 28, 38 |
| *South American Gold & Platinum Co. v. Commissioner*, 8 T.C. 1297 (1947), *aff'd*, 168 F.2d 71 (2d Cir. 1948) | 19, 25, 26 |
| *Tilford v. Commissioner*, 75 T.C. 134 (1980), *rev'd*, 705 F.2d 828 (6th Cir.), *cert. denied*, 464 U.S. 992 (1983) | 27, 28 |
| *United States v. Chicago, B. & Q. R. Co.*, 412 U.S. 401 (1973) | 20 |
| *United States v. Davis*, 397 U.S. 301, *reh'g denied*, 397 U.S. 1071 (1970) | 31, 33 |
| *United States v. Davis*, 370 U.S. 65, *reh'g denied*, 371 U.S. 854 (1962) | 16 |
| *United States v. Foster Lumber Co.*, 429 U.S. 32 (1976) | 34 |
| *United States v. Hughes Properties, Inc.*, 106 S. Ct. 2092 (1986) | 37 |
| *Wright v. Commissioner*, 18 B.T.A. 471 (1929), *modified on another issue*, 47 F.2d 871 (7th Cir. 1931) | 28, 29 |


STATUTES AND REGULATIONS:


Internal Revenue Code (26 U.S.C. (& Supp. II)):

| | |
|---|---|
| § 83 | 8, 9, 26, 27, 28 |
| § 83(h) | 26 |
| § 161 | 11 |
| § 162 | 25, 27 |
| § 165 | 11 |

TABLE OF AUTHORITIES—Continued


| | Page |
|---|---|
| § 165(a) | 4, 6, 11, 12, 32, 38, 1a |
| § 165(b) | 38, 1a |
| § 165(c) | 11, 36, 37, 1a |
| § 165(c)(1) | 11, 25, 1a |
| § 165(c)(2) | 4, 6, 11, 17, 25, 32, 1a |
| § 165(g) | 10, 36, 37 |
| § 263 | 12 |
| § 302 | 9, 10, 30-35 |
| § 304 | 30 |
| § 305 | 30 |
| § 306 | 30 |
| § 317(a) | 21 |
| § 317(b) | 22, 34 |
| § 341 | 30 |
| § 1001(a) | 11, 32, 1a-2a |
| § 6654 | 34 |
| Treas. Reg. (26 C.F.R.): | |
| § 1.61-6(a) | 18 |
| § 1.61-12(a) | 19 |
| § 1.83-6(d) | 26, 27 |
| § 1.165-1(a) | 12, 2a |
| § 1.165-1(b) | 12, 14, 2a |
| § 1.165-1(c) | 38, 2a-3a |
| § 1.263(a)-2(f) | 18, 19 |
| § 1.302-2(c) | 33 |
| § 1.1001-1(a) | 15, 39 |
| § 1.1012-1(c)(1) | 16, 17 |
| Mich. Comp. Laws § 450.1110(2) (1979) | 21 |
| MISCELLANEOUS: | |
| Acquiescence, 1976-1 C.B. 1 | 29 |
| B. Bittker, *Federal Taxation of Income, Estates and Gifts* (1981) | 16, 17, 25 |
| B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (4th ed. 1979) | 12, 19, 33 |
| J. Burton, R. Palmer & R. Kay, *Handbook of Accounting and Auditing* (1983) | 21 |




TABLE OF AUTHORITIES—Continued


| | Page |
|---|---|
| H. Guthmann & H. Dougall, *Corporate Financial Policy* (4th ed. 1940) | 21 |
| Harvey, *Some Indicia of Capital Transfers Under the Federal Income Tax Laws*, Mich. L. Rev. 745 (1939) | 21 |
| H.R. Rep. No. 1860, 75th Cong., 2d Sess. (1938) | 36 |
| G. Johnson & J. Gentry, *Finney and Miller's Principles of Accounting* (7th ed. 1974) | 20, 21, 22 |
| R. Marple, *Capital Surplus and Corporate Net Worth* (1936) | 21 |
| J. Mertens, *Law of Federal Income Taxation* (1986) | 38 |
| W. Meigs & R. Meigs, *Financial Accounting* (4th ed. 1983) | 21 |
| Rev. Rul. 69-368, 1969-2 C.B. 27 | 30 |
| Rev. Rul. 59-60, 1959-1 C.B. 237 | 15, 39 |
| Rev. Rul. 58-402, 1958-2 C.B. 15 | 15 |
| L. Seidler & D. Carmichael, *Accountants' Handbook* (1981) | 21 |
| S. Rep. No. 552, 91st Cong., 1st Sess. (1969) | 26 |
| Withdrawal of acquiescence, 1977-1 C.B. 2 | 29 |

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

---

No. 86-511

---

COMMISSIONER OF INTERNAL REVENUE,
*Petitioner,*

v.

PETER R. FINK ET UX.,
*Respondents.*

---

**On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit**

---

## BRIEF FOR RESPONDENTS

---

### STATUTE AND REGULATIONS INVOLVED

The relevant portions of Sections 165 and 1001 of the Internal Revenue Code (26 U.S.C.) and Section 1.165-1 of the Treasury Regulations on Income Tax (26 C.F.R.) are set out in an appendix (App., *infra*, 1a-3a).

### STATEMENT

This statement includes material facts which were omitted from the statement of the government. These additional facts, which were relevant to the courts below and which respondents believe should be considered by this Court, are as follows:

1. In 1964, respondents, Peter R. Fink and Karla S. Fink, and five other individuals purchased all of the stock of Frank Motor Homes, Inc., a Michigan corporation that manufactured motor homes (Pet. App. 24a). Subsequently, that corporation was renamed Travco Corporation ("Travco"). Travco had authorized and outstanding one class of common stock and no preferred stock (*id.* at 27a-28a). During the years 1964 through 1976, Mr. Fink invested approximately $835,000 in common stock of Travco, and Mrs. Fink invested approximately $1,060,000 in that stock (*id.* at 25a). As of December 31, 1976, there were 1,536,146 shares of Travco common stock outstanding, of which Mr. Fink owned 802,300 shares, or 52.2 percent, and Mrs. Fink owned 311,359 shares, or 20.3 percent (*id.* at 27a-30a). These stock investments were made with an actual and honest objective of making an economic profit (*id.* at 25a-26a).

2. The energy crisis of 1973 and 1974 caused a downturn in the market for motor homes, resulting in a decline in Travco's earnings and a weakening of its financial condition (*id.* at 25a). During 1976, Travco was heavily pressured by its primary lender, Manufacturers National Bank of Detroit ("Manufacturers"), to repay its borrowings (*id.* at 26a). During 1975 and 1976, Mr. Fink, on behalf of Travco, sought additional capital for Travco from a broad range of sources, but was unsuccessful (*id.* at 26a-27a). In this connection, Travco engaged an independent investment adviser to advise it on how to attract outside investors (*id.* at 27a). In late 1976, Travco negotiated with City National Bank of Detroit ("City National") to replace Manufacturers as its primary lender (*ibid.*). As a condition of extending credit, City National required that Travco obtain $900,000 of new capital, and agreed that it could consist of $700,000 in equity and $200,000 in subordinated debt (*ibid.*).



3. In order to improve Travco's financial position, to preserve its business, to increase the attractiveness of the corporation to outside investors, and not primarily for tax motives, respondents surrendered shares of Travco common stock to the corporation (*id.* at 28a-29a). On December 22, 1976, Mr. Fink surrendered to Travco 116,146 shares having an adjusted basis of $197,781.64. On January 6, 1977, Mrs. Fink surrendered to Travco 80,000 shares having an adjusted basis of $191,257.61. These shares were unilaterally surrendered without consideration from Travco, and were not connected to any indirect transfer to any third party. No other shareholder surrendered any shares of Travco stock. The surrendered shares were held by Travco as treasury stock at zero value. As a result of these stock surrenders, respondents' combined percentage interest in Travco was reduced from 72.5 percent to 68.5 percent (*id.* at 30a).

4. In order to meet the capital requirements imposed by City National, it was contemplated that Travco would issue $700,000 in new equity in the form of $1.00 par value preferred stock, convertible into common shares on a 2:1 ratio, and $200,000 in subordinated notes (*id.* at 29a). Respondents' stock surrenders were intended to make these investments more attractive to outside investors by providing such investors with the opportunity to obtain control of the corporation (*ibid.*). By surrendering a combined total of 196,146 shares, respondents reduced the total number of outstanding Travco common shares from 1,536,146 to 1,340,000 (*id.* at 30a). This reduction was designed to attract new investors to purchase the 700,000 shares of preferred stock, who would then be in a position to convert them into 1,400,000 shares of common stock and thereby gain control of the corporation (*id.* at 29a). In that event, respondents' combined percentage interest in the corporation would have been reduced from 72.5 percent to approximately 33.5 percent. Although respondents held Travco debt

that was convertible into common stock, it would not have been practical for them to make the conversion (*ibid.*). Thus, had the 700,000 shares of preferred stock been purchased by an outside investor and converted, there was little likelihood that respondents could have regained control of the corporation (*ibid.*).

5. In 1977, Travco offered the $700,000 issue of preferred stock and the $200,000 of subordinated debt (*id.* at 31a). No outside investor could be found, however, for either the preferred stock or the debt. During 1977, respondents and Elise M. Fink, Mr. Fink's mother, each acquired one-third of the preferred stock and one-third of the subordinated debt. Thereafter, City National replaced Manufacturers as Travco's primary lender. During the years 1978 through 1980, Travco's financial condition continued to deteriorate due to the continuing energy crisis, and a substantial portion of its assets were sold. Travco's creditors were paid to the extent possible, and the corporation was liquidated (*id.* at 31a-32a).

6. On their 1976 joint income tax return, respondents claimed an ordinary loss deduction of $197,781.64, representing the basis of the 116,146 shares of Travco common stock surrendered in 1976 by Mr. Fink (*id.* at 32a). On their 1977 joint return, respondents claimed an ordinary loss deduction of $191,257.61, representing the basis of the 80,000 shares of Travco common stock surrendered in 1977 by Mrs. Fink. The loss deductions were claimed under Section 165(a) and (c)(2) of the Internal Revenue Code, 26 U.S.C. (the "Code" or "I.R.C.") (*id.* at 2a), which allows individuals a deduction for "any loss sustained during the taxable year," if the loss is incurred in a "transaction entered into for profit." In his statutory notice of deficiency, the Commissioner disallowed those claimed deductions, determining that the surrenders of common stock to Travco constituted contributions to its capital (*id.* at 32a).



7. The Tax Court entered its decision for the Commissioner, holding that a non-pro rata surrender of stock to the issuing corporation "is not an event that permits the recognition of loss and constitutes instead a contribution to the capital of the corporation" (*id.* at 33a). That court held that respondents' basis in the surrendered shares must be added to the basis of their remaining shares. In reaching these conclusions, the court relied on its reviewed opinion, with four dissents, in *Frantz v. Commissioner*, 83 T.C. 162 (1984), *aff'd*, 784 F.2d 119 (2d Cir. 1986), *petition for cert. pending*, No. 86-11. In the *Frantz* case, the Tax Court overruled its own decisions and decisions of the Board of Tax Appeals dating back to 1929, which uniformly held that a surrender of stock to the issuing corporation gives rise to an immediately deductible loss. In so doing, the Tax Court majority followed the decision in *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979), which itself had reversed an earlier decision of the Tax Court (*Smith v. Commissioner*, 66 T.C. 627 (1976)) in this 50-year old line of cases.

8. On appeal here, with one judge dissenting, the court of appeals reversed the Tax Court's decision in the Commissioner's favor. The court explained (Pet. App. 11a) that the holder of shares in a corporation "is entitled to a variety of rights, such as the right to receive dividends, the right to share in corporate assets on dissolution, and the right to vote on corporate matters." In the case of a non-pro rata surrender of shares, the court continued (*ibid.*), "these rights are relinquished, and the shareholder's proportionate ownership interest is reduced. . . . Consequently, the surrendering shareholder suffers an immediate loss." The court further reasoned (*id.* at 15a) that a non-pro rata surrender of shares cannot properly be considered a contribution to capital: "When cash or property is given to the corporation, the corporation's capital is increased by the value of the property contributed. . . . When a shareholder makes a

non-pro rata surrender, corporate capital is not increased but the shareholder's proportionate percentage of ownership is reduced." Relying on Judge Parker's dissenting opinion in the Tax Court in *Frantz*, the court said (*ibid.*) "we cannot disregard 'the fact that a cash contribution does not change the shareholder's proportionate ownership interest in the corporation vis-a-vis the other shareholders whereas the non-pro rata surrender of shares does.' 83 T.C. at 191 (Parker, J., dissenting)."

9. Accordingly, the court of appeals held that respondents are entitled to loss deductions for the years 1976 and 1977 as a result of their surrenders of Travco common stock in those years (*id.* at 16a). In addition, the court held that the loss deductions are ordinary, rather than capital, in character since the surrenders did not constitute a sale or exchange, and that the amount of those deductions should be measured by the basis of the stock surrendered less any resulting increase in the value of the stock retained (*id.* at 14a, 16a). The court of appeals remanded to the Tax Court "for a determination of whether the surrender of the stock by the taxpayers resulted in an increase in the value of their remaining shares" (*id.* at 16a). "Barring such a finding," the court continued, "the taxpayers are entitled to an ordinary loss deduction for the full amount of their basis in the surrendered shares" (*ibid.*).

10. The sole issue presented for decision here is whether a non-pro rata surrender of stock to the issuing corporation gives rise to an immediately deductible loss.

## SUMMARY OF ARGUMENT

### I

Respondents' non-pro rata stock surrenders gave rise to actual losses that are immediately deductible under the loss rules of Section 165(a) and (c)(2). These stock surrenders resulted in real economic losses because they reduced respondents' interests in the corporation and



their attendant rights to dividends, future appreciation, assets upon liquidation, and voting. Non-pro rata stock surrenders give rise to actual losses in the same way, and for the same reason, that non-pro rata stock dividends result in income—they change the shareholder's proportionate interest in the corporation. The losses that are actually sustained upon stock surrenders are incurred precisely at the moment that the shares are surrendered. Since no further event is necessary to create or evidence the losses, the losses thus sustained result from "closed" transactions and are immediately deductible. The conclusion is the same regardless of whether the shares held by the stockholder are viewed individually under the so-called "fragmentary" theory of stock ownership or collectively under the "unitary" theory. Under either theory, the surrender of shares results in a diminution of the shareholder's interest and the realization of a loss that the tax law allows.

### II

The government's principal argument is that non-pro rata stock surrenders are indistinguishable from, and therefore constitute, contributions to capital. This argument is erroneous and fails to recognize two critical distinctions between the transactions. First, in the case of every contribution to capital, the shareholder, by transferring cash or other property to the corporation, by forgiving its indebtedness, or by paying its liabilities, actually increases the net worth or "capital" of the corporation. Second, in the case of every contribution to capital, the proportionate interest of the contributing shareholder in the corporation, evidenced by the stock owned, is unaffected by the transaction. In both of these respects, non-pro rata stock surrenders produce distinctly different results. First, since a corporation's own stock cannot be an asset of the corporation, and since a stock surrender relieves no corporate liability, a surrender of stock to the issuing corporation does not increase its net worth or "capital." Second, a non-pro rata

stock surrender perforce changes the proportionate interest of the surrendering shareholder in the corporation. Accordingly, contributions to capital and non-pro rata stock surrenders are disparate transactions that call for disparate tax treatment.

The government's related theory—that non-pro rata stock surrenders come within some more general class of nondeductible capital expenditures—is equally flawed. A capital expenditure represents an increased financial commitment to an existing investment. A non-pro rata stock surrender is essentially the reverse: the stockholder relinquishes altogether the investment represented by the surrendered shares. Since the surrender transaction reduces the shareholder's proportionate interest in the corporation, the surrendered shares cannot be considered capitalized or assimilated into any remaining investment in the corporation. The surrendering shareholder is sustaining a loss, not making an expenditure. For this reason, the tax treatment of stock surrenders is not controlled by the series of cases relied on by the government, in which shareholders were denied ordinary and necessary business expense deductions for expenditures made to benefit their corporations. All of those cases are distinguishable since they involve situations in which a shareholder either attempted to deduct a corporate expense, or actually made an additional investment in the corporation by paying an expense of the corporation.

Section 83 has no application to the issue presented here. Under that provision, a stock transfer by a shareholder to a corporate employee in compensation for services rendered to the corporation represents income to the employee. Section 83 allows the corporation to take a corresponding business expense deduction. This rule was necessary to avoid denial of a business expense deduction to both the shareholder (because the compensation expense did not arise in his "trade or business") and the corporation (because it had not paid or incurred the ex-



pense). The Treasury Regulations, which provide that in such a case the shareholder is to be treated as if he had made a contribution to the capital of the corporation, simply reflect the principle that a shareholder makes a nondeductible contribution to capital when he pays an expense of his corporation. Neither Section 83 nor its regulations pertain to stock surrenders, such as those involved in this case, that are unrelated to employee compensation.

## III

In holding for respondents, the court of appeals followed principles long accepted by courts, the Internal Revenue Service, and Congress. Court decisions allowing immediate loss deductions upon non-pro rata stock surrenders, including decisions of three other courts of appeals, span a period of a half-century, from 1929 to 1979. The government's position here, which rests on two contrary decisions of other courts of appeals rendered in 1979 and 1986, would sweep aside those cases. That position, moreover, departs from a published position which the Internal Revenue Service maintained for 35 years, and seeks to reverse a construction of the tax laws accepted by Congress.

The government asserts that allowance of immediate loss deductions upon non-pro rata stock surrenders would be inconsistent with Code provisions which concededly do not apply to stock surrenders, and would also create serious tax-avoidance possibilities. These claims are spurious.

Because Section 302 is inapplicable to stock surrenders, the "redemption principles" cited by the government are irrelevant here. The sole purpose of Section 302 is to prevent the "bailout" of corporate earnings at capital gain rather than ordinary income rates. Section 302 applies only where property is distributed by a corporation in exchange for stock. In a stock surrender, the

corporation distributes no property, and stock is not exchanged. Since redemption and surrender transactions are dissimilar, there is no basis on which to equate them and no reason to require that their tax consequences be reconciled.

The government says that if a distribution in redemption is treated as a dividend under the anti-bailout rules of Section 302 rather than as having been made in exchange for stock, the shares redeemed are treated as having been contributed to capital. This is incorrect. Even if a distribution in redemption is treated as a dividend, no contribution to capital results because the transfer of the shares does not increase the capital of the corporation. Indeed, the effect of the redemption is to decrease the capital of the corporation by the amount of the distribution from the corporation.

The government may be correct in stating that the tax consequences of respondents' transactions would have been different if they had received even a miniscule amount of consideration in exchange for their shares. However, respondents did not receive any consideration in exchange for their shares, and no provision of law requires that they be treated as if they had. At bottom, the government is simply asking the Court to adopt a body of rules that Congress has not seen fit to prescribe through legislative enactment.

The government contends that allowing loss deductions upon stock surrenders would enable shareholders of failing corporations to avoid Section 165(g), which generally requires capital loss treatment upon the worthlessness of corporate stock. In this case, respondents' stock surrenders were made for the sound business purposes of preserving Travco and attracting new capital for its business, and were not primarily tax motivated. To the extent that future transactions in other situations are abusive, the government is adequately equipped to counteract them under traditional doctrines. Section 165(g)



represents a Congressional determination to remove worthless stock losses from the scope of the ordinary loss rules of Section 165(c). Congress has made no similar determination with respect to losses from stock surrenders.

There is no merit to the government's claim that exceptional computational difficulties are created by the court of appeals' method of determining respondents' losses. The methodology employed is the same as that utilized by other courts in similar situations and fully comports with the general rules that apply in determining the amount of losses.

## ARGUMENT

### I. RESPONDENTS' NON-PRO RATA SURRENDERS OF STOCK GAVE RISE TO IMMEDIATELY DEDUCTIBLE LOSSES

The rules that control the proper disposition of this case are straightforward. Section 1001(a) of the Code provides that gain or loss is realized on the sale "or other disposition" of property. Section 165(a) prescribes the general rule that "any loss sustained during the taxable year" is currently deductible. In the case of individuals, the statute limits the losses deductible under Section 165(a) to those incurred "in a trade or business" (Section 165(c)(1)) or "in any transaction entered into for profit" (Section 165(c)(2)). Since respondents acquired their Travco common stock with the requisite profit motive, disposed of it, and thereby sustained actual losses, they are entitled to deduct those losses currently under Section 165(a) and (c)(2).[1]

---

[1] Respondents do not claim that their losses were incurred in a trade or business and thus do not claim deductions under Section 165(c)(1). As discussed below (*infra* pp. 24-28), this fact renders portions of the government's argument superfluous.

Section 161 provides that losses described in Section 165 are immediately deductible unless another Code provision specifically

### A. Upon the Surrender of Their Stock, Respondents Actually Sustained Immediately Deductible Losses

The Treasury Regulations provide that to be deductible under Section 165(a), a loss must be "actually sustained during the taxable year." Treas. Reg. § 1.165-1 (a) and (b). In this case, respondents had made substantial investments in Travco common stock. Each share of such stock represented a permanent proprietary ownership interest in the corporation, entitling respondents to dividends, future appreciation, assets upon liquidation, and the right to vote in the corporation's affairs. See *Eisner v. Macomber*, 252 U.S. 189, 208 (1920); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.31, at 14-94 to 14-95 (4th ed. 1979). As the court of appeals correctly observed (Pet. App. 11a), all of these rights and benefits inherent in the shares surrendered were lost upon their surrender. It follows that, as a result of the surrenders, respondents actually sustained deductible losses.

The government concedes (Br. at 16) that such surrenders "might be called a 'loss' in a colloquial sense," but fails to acknowledge that respondents' losses were indeed real.[2] The fact that, upon surrender of the stock,

---

overrides and renders them nondeductible. The only disallowance provision that the government argues is pertinent to this case is Section 263, which disallows a deduction for capital expenditures. As demonstrated below (*infra* pp. 18-28), the stock surrenders here in issue did not constitute capital expenditures and, therefore, Section 263 does not bar deduction of the losses claimed.

[2] Apparently, the government contends that a loss that admittedly exists in a "colloquial sense" nevertheless might not be allowable. Only a month ago, however, this Court reaffirmed that "common-sense concept[s]" are not to be so lightly discarded. *Commissioner v. Groetzinger*, 55 U.S.L.W. 4175, 4179 (U.S. Feb. 24, 1987). See also *Malat v. Riddell*, 383 U.S. 569, 571 (1966) (citing *Crane v. Commissioner*, 331 U.S. 1, 6 (1947), for the proposition that tax statutes "should be interpreted where possible in their



respondents relinquished rights to dividends, future appreciation, assets upon liquidation, and voting rights inherent in the shares surrendered means that they sustained immediate and actual losses. See *Eisner v. Macomber*, 252 U.S. at 212; *Scherman v. Helvering*, 74 F.2d 742, 743 (2d Cir. 1935). Moreover, this Court has consistently recognized that non-pro rata stock transactions have real consequences and thus are events that give rise to immediate tax results. In its landmark decision in *Eisner v. Macomber*, 252 U.S. at 210-11, the Court held that a pro rata stock dividend is not taxable as income because "it does not alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of his holding . . . ." Subsequently, in *Koshland v. Helvering*, 298 U.S. 441, 446 (1936), the Court contrasted pro rata stock dividends and non-pro rata stock dividends and held that "where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income." It has been settled ever since the *Koshland* case that non-pro rata increases in stock holdings are taxable events and that the shareholder whose stock holdings increase realizes taxable income. *Helvering v. Gowran*, 302 U.S. 238 (1937), *reh'g denied*, 302 U.S. 781 (1938); *Helvering v. Sprouse*, 318 U.S. 604 (1943). The controlling fact that makes non-pro rata stock dividends taxable events creating currently taxable income is that the transactions alter the shareholder's preexisting proportionate interest in the corporation. This principle applies equally to a non-pro rata stock surrender, which also "gives the stockholder an interest different from that which his former stock holdings represented." *Koshland v. Helvering*, 298 U.S. at 446.

---

ordinary, everyday senses"). No Code provision or other doctrine requires a departure from the common-sense rule in this case.

### B. Respondents' Non-Pro Rata Stock Surrenders Were Closed and Completed Transactions

The Treasury Regulations require that, in order to be deductible, losses must be "evidenced by closed and completed transactions [and] fixed by identifiable events." Treas. Reg. § 1.165-1(b). The non-pro rata stock surrenders here in issue clearly satisfied these requirements. Respondents' surrenders of common stock to Travco were irrevocable, and actually reduced their interests in the corporation. The resulting losses of rights and benefits inherent in the surrendered shares were complete, immediate, and irreversible. The stock surrenders were, in and of themselves, complete and final dispositions of the shares, and were the "identifiable events" required by the regulation. No further event was necessary to consummate the transactions.

Nevertheless, the government contends (Br. at 14-16) that the surrenders in issue are open transactions, arguing that the surrenders were intended to preserve or increase the value of respondents' remaining shares and, therefore, that the transactions were not closed until respondents disposed of their remaining shares. This contention is erroneous for two reasons.

First, the government is in error in asserting that the tax treatment of the transactions depends on respondents' motives for the surrenders, since motive has no bearing on the question whether a transaction is open or closed. For example, a taxpayer who sells stock of one corporation at a loss so that he can use the proceeds to purchase stock of another corporation is not for that reason barred from deducting the loss and required to add the amount of the loss to the basis of his new stock. Likewise, motive has been found irrelevant to the tax treatment of stock dividends which, as described above, are the reverse of surrender transactions. In *Chamberlin v. Commissioner*, 207 F.2d 462, 469 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954), the court, referring



to this Court's decisions in *Koshland* and its progeny, explained that "[t]he Supreme Court cases in no way suggest that the taxability of a stock dividend depends on the purpose of its issuance . . . . The decisions are based squarely upon the proportional interest doctrine." So here the proportional interest doctrine is controlling. Under that doctrine, a taxpayer's motive does not serve to hold open a transaction that, by all other standards, is closed.

Second, the government is in error in its claim that because respondents' stock surrenders were intended in part to improve Travco's financial position, and because the surrenders might thereby enhance the value of respondents' remaining shares, the transactions had to be held open until those remaining shares were disposed of. If the surrenders in question did enhance the value of respondents' remaining shares, that enhancement occurred at the time of the surrenders, not at any subsequent date. Reflecting this fact, the court of appeals remanded to the Tax Court specifically "for a determination of whether the surrender[s] of stock by the taxpayers resulted in an increase in the value of their remaining shares" (Pet. App. at 16a). The government elsewhere admits (Br. at 37) that the Tax Court can perform this valuation on the basis of facts extant at the time of the surrenders, suggesting only that the valuation may be difficult to perform. The Internal Revenue Service has ruled, however, that a transaction should be considered an open transaction "because of unusual uncertainties with respect to valuations [only] in rare and extraordinary cases." Rev. Rul. 58-402, 1958-2 C.B. 15, 17. See also Treas. Reg. § 1.1001-1(a). No unusual circumstances are present in this case to prevent valuation. If need be, resort may be had to detailed guidelines published by the Internal Revenue Service for the valuation of stock. See Rev. Rul. 59-60, 1959-1 C.B. 237. It is well within the ability of the Tax Court to determine value on remand, and it should be allowed to do so.

Open transactions are "seldom encountered in practice." 2 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 43.2, at 43-7 (1981). This reflects the teaching of this Court that transactions generally should be considered closed rather than open. For example, in *United States v. Davis*, 370 U.S. 65, 72-73 (1962), the Court explained that "once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences." There is no reason for departing from this sound principle here.

### C. Respondents Are Entitled to Prevail Under Either the "Fragmentary" or the "Unitary" Theory of Stock Ownership

The courts that have considered the question presented here, including the court of appeals below (Pet. App. at 10a-14a), have focused a great deal of attention on what have been termed the "fragmentary" and the "unitary" theories of stock ownership. Our position is that the "fragmentary" theory is correct and that analysis under that theory supports the conclusion that losses sustained upon non-pro rata stock surrenders are immediately deductible. As will be shown, however, respondents are entitled to prevail under the "unitary" theory as well.

The "fragmentary" theory of stock ownership has been generally accepted by both the courts and the Internal Revenue Service. As the government admits (Br. at 21), it is a "well-settled rule" that shares of stock are just like other types of property, "with gain or loss being computed by reference to their individual bases." See Treas. Reg. § 1.1012-1(c)(1); *Davidson v. Commissioner*, 305 U.S. 44 (1938); *Helvering v. Rankin*, 295 U.S. 123 (1935). The "fragmentary" theory recognizes that each share of stock constitutes a separate investment and that dispositions of individual shares, whether by sale or exchange, or by surrender to the issuing corporation, are transactions involving discrete property. Thus, the tax consequences that result from a transaction involving individual shares must be immediately recognized, whether or not the taxpayer continues to hold other shares. The "fragmentary" theory of stock ownership therefore supports respondents' contention that upon their surrenders of common stock they sustained immediately deductible losses.



Under the "unitary" theory, as described by some courts, shares of stock would be viewed as a "single, indivisible property unit." *Frantz v. Commissioner*, 83 T.C. at 188 (Parker, J., dissenting). Courts that have followed this theory have drawn the corollary that whenever a transaction might conceivably benefit any retained shares, "the transaction would not close until the taxpayer disposed of his retained shares . . . ." *Frantz v. Commissioner*, 784 F.2d at 124.[3] Both the theory and its corollary are wrong, but the corollary would be wrong even if the theory were correct. As discussed in the preceding paragraph, the Treasury Regulations expressly reject the theory, by requiring each share of stock to be treated as a separate investment. Treas. Reg. § 1.1012-1(c)(1). The regulations also expressly reject the corollary. In those situations where there is a larger unitary property to begin with, the regulations state that upon the sale of parts of the "larger property," the "sale of

---

[3] The "unitary" theory has also been applied to suggest that the relevant "transaction entered into for profit" begins when shares are surrendered, that the purpose of such transaction is to enhance the value of the retained shares, and that this transaction cannot be "closed" until the retained shares are disposed of. As the court of appeals recognized (Pet. App. 13a), this reasoning "ignores the well-settled principle that the profit objective for purposes of section 165(c)(2) is determined when the property is acquired." See 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 25.3 (1981). If the rule were otherwise, no disposition of depreciated property could ever produce a deductible loss.

each part is treated as a separate transaction and gain or loss shall be computed separately on each part . . . at the time of sale of each part and not deferred until the entire property has been disposed of."[4] Treas. Reg. § 1.61-6(a). It follows that even if their entire stock interest in Travco is viewed as a single property under the "unitary" theory, respondents are entitled to deduct immediately the loss associated with the surrender of a portion of that interest.

## II. CONTRARY TO THE GOVERNMENT'S ARGUMENTS, RESPONDENTS' NON-PRO RATA SURRENDERS OF STOCK WERE NEITHER CONTRIBUTIONS TO CAPITAL NOR ANY OTHER TYPE OF CAPITAL EXPENDITURE

The government's principal argument is that a non-pro rata stock surrender constitutes a "prototypical contribution to capital" (Br. at 7, 10). On this point, the government contends that a non-pro rata surrender of stock to the issuing corporation is indistinguishable from the transfer to the corporation of cash or other property. In addition, the government contends that a non-pro rata stock surrender "falls into the prototypical mold of a [nondeductible] capital expenditure" (*id.* at 17). On both scores the government is plainly wrong.

### A. Respondents' Non-Pro Rata Surrenders of Stock Were Not Contributions to Capital

The government contends (Br. at 10) that non-pro rata stock surrenders fall within the rule that "voluntary contributions by shareholders to the capital of the corporation . . . are capital investments and are not deductible." Treas. Reg. § 1.263(a)-2(f). This contention is incorrect. As we will now show, a surrender of stock does not constitute a contribution "to the capital of the

[4] While the regulations state this rule in the context of a sale rather than a surrender, no reason is apparent why the rule should apply only to sales, rather than to all dispositions of property.



corporation." Hence, the rule cited by the government is inapplicable.

We agree with the government (Br. at 13) that voluntary contributions of money or other property by a shareholder to the capital of a corporation constitute nondeductible contributions to capital. Treas. Reg. § 1.263(a)-2(f); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 3.14, at 3-59 (4th ed. 1979). This general rule applies whether the shareholder contributes cash, tangible property, or securities issued by other entities. The rule also applies when the shareholder forgives debt of the issuing corporation. See, *e.g.*, Treas. Reg. § 1.61-12(a); *Perlman v. Commissioner*, 252 F.2d 890 (2d Cir. 1958), *aff'g* 27 T.C. 755 (1957); *Lidgerwood Manufacturing Co. v. Commissioner*, 229 F.2d 241 (2d Cir.), *cert. denied*, 351 U.S. 951 (1956); *Bratton v. Commissioner*, 217 F.2d 486 (6th Cir. 1954). Similarly, the rule applies when the shareholder, rather than transferring cash or property directly to the corporation, transfers cash or property to a third party in order to satisfy a liability of the corporation to that third party. See, *e.g.*, *Rittenberg v. United States*, 267 F.2d 605 (5th Cir. 1959), *cert. denied*, 361 U.S. 931 (1960); *South American Gold & Platinum Corp. v. Commissioner*, 8 T.C. 1297, *aff'd*, 168 F.2d 71 (2d Cir. 1948); *Eskimo Pie Corp. v. Commissioner*, 4 T.C. 669 (1945), *aff'd*, 153 F.2d 301 (3d Cir. 1946) (per curiam); *Ihrig v. Commissioner*, 26 T.C. 73 (1956). In each of these situations, the shareholder has, by either increasing corporate assets or decreasing corporate liabilities, increased corporate net worth and, thus, made a contribution to corporate "capital."

The government asserts (Br. at 10) that non-pro rata surrenders of stock to the issuing corporation are indistinguishable from the above-described situations and thus also constitute contributions to capital. This assertion is wrong, primarily because it ignores (Br. at 8, 21-22)

two critical distinctions that separate non-pro rata surrenders of stock to the issuing corporation from contributions of other types of property. These distinctions not only differentiate non-pro rata stock surrenders from contributions to capital, but actually require that they be treated differently.

As described above, a contribution of cash or other property to a corporation, the forgiveness of the corporation's debt, or the payment of its liabilities, increases the corporation's net worth. See, *e.g.*, *Perlman v. Commissioner*, 252 F.2d at 892; *Lidgerwood Manufacturing Co. v. Commissioner*, 229 F.2d at 242. As this Court has explained, a contribution to capital actually results in an increase in the corporation's "capital." See *United States v. Chicago, B. & Q. R. Co.*, 412 U.S. 401, 412-13 (1973); *Brown Shoe Co. v. Commissioner*, 339 U.S. 583, 589-91 (1950). In contrast to actual contributions to capital, non-pro rata stock surrenders do not involve transfers of property that increase the net worth or capital of the corporation.[5] Stock surrendered to the issuing corporation merely embodies an ownership interest in the corporation, and "[a] corporation that acquires its own stock obviously cannot acquire the basic rights inherent in stock ownership . . . ." G. Johnson & J. Gentry, *Finney and Miller's Principles of Accounting* 538 (7th ed. 1974). Reflecting this economic reality, it is universally understood that whenever a shareholder surrenders stock to the corporation—even when the corporation holds that stock as treasury stock—the corporation is not treated as having acquired a corporate asset, and the corporation's net worth or capital remains the same after the surrender as it was before. See *Eisner v. Macomber*, 252

[5] Similarly, pro rata stock surrenders do not constitute contributions to capital. Just as pro rata stock dividends "really take nothing from the property of the corporation," pro rata stock surrenders add nothing to the property of the corporation. See *Eisner v. Macomber*, 252 U.S. at 212.



U.S. at 215 (holding that a "corporation's own shares" do not constitute "assets of the company"); G. Johnson & J. Gentry, *supra*, at 538; W. Meigs & R. Meigs, *Financial Accounting* 467 (4th ed. 1983); 2 L. Seidler & D. Carmichael, *Accountants' Handbook* 29.16 (1981); J. Burton, R. Palmer & R. Kay, *Handbook of Accounting and Auditing* 26-19 to 26-20 (1981); H. Guthmann & H. Dougall, *Corporate Financial Policy* 137 (4th ed. 1940); R. Marple, *Capital Surplus and Corporate Net Worth* 137 (1936); Harvey, *Some Indicia of Capital Transfers under the Federal Income Tax Laws*, 37 Mich. L. Rev. 745, 747 n.6 (1939); *Christie v. Fifth Madison Corp.*, 211 N.Y.S.2d 787, 795 (1961). The Internal Revenue Code itself recognizes this principle, providing, for a variety of purposes, that the term property "does not include stock in the [issuing] corporation." I.R.C. § 317(a).

In this case the surrendered Travco common stock was held by Travco as treasury stock at zero value (Pet. App. 28a). This treatment accords not only with economic reality and the universally accepted accounting principles described above, but also with Michigan law, which provides that "[t]reasury shares . . . are not assets." Mich. Comp. Laws § 450.1110(2) (1979). As the court below held (Pet. App. 15a), since the surrendered stock did not increase Travco's "capital," the surrender transactions could not possibly be considered contributions "to capital."

Despite the clarity of the rule that treasury stock does not constitute a corporate asset and does not increase the capital of a corporation, the government attempts (Br. at 23-24) to characterize such stock as "functionally equivalent to an asset." This characterization is based on the fragile premise that treasury stock might, at some future time, be reissued to acquire actual assets or to discharge corporate liabilities and, in turn, actually increase capital. On this theory, unissued stock would also

be considered an asset of the corporation, and every corporation would have capital that was limited only by the amount of its authorized stock. However, "it seems obvious that treasury stock, like unissued stock, is not an asset but merely a possible source of additional funds." G. Johnson & J. Gentry, *supra*, at 538; *Christie v. Fifth Madison Corp.*, 211 N.Y.S.2d at 795; I.R.C. § 317(b) (no distinction made between stock which is "cancelled, retired, or held as treasury stock").[6]

The government's capital contribution theory also ignores a second critical distinction between capital contributions and non-pro rata stock surrenders. This distinction rests on "the fact that a cash [or other property] contribution does not change a shareholder's proportionate interest in the corporation vis-a-vis the other shareholders, whereas the non pro rata surrender of shares, does." *Frantz v. Commissioner*, 83 T.C. at 191 (Parker, J., dissenting). When a shareholder contributes cash or other property and his proportionate interest in the corporation remains unchanged, it is appropriate to treat the contribution as a non-taxable event. On the other hand, when a shareholder's proportionate interest in the corporation does change, this Court long ago held that it is proper to determine immediately the tax consequences of that event. See *Koshland v. Helvering*, 298 U.S. at 446. Since a non-pro rata stock surrender changes the surrendering shareholder's proportionate interest in the corporation, it is necessary to recognize the tax consequences at the time of such change.

[6] If a distinction were to be drawn between treasury stock and unissued stock, then there presumably would be no contribution to capital upon a stock surrender if a corporation simply cancelled or retired surrendered stock thereby rendering it unissued. While the government seems to imply (Br. at 24) that it would draw a line between treasury stock and cancelled or retired stock, we doubt that the Internal Revenue Service would have allowed the losses here in dispute if the shares respondents surrendered had been cancelled or retired instead of being kept in Travco's treasury.



### B. Respondents' Non-Pro Rata Surrenders of Stock Were Not Otherwise Capital Expenditures

As demonstrated above, non-pro rata stock surrenders do not constitute contributions to capital. Such surrenders likewise do not fall within some broader category of nondeductible capital expenditures.

In *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 14 (1974), the Court explained that an "expenditure" must be capitalized when the investment represented by that expenditure "is assimilated into the cost of" another asset. In such a case, there is no "final disposition" of the investment, but rather a full continuation of the investment in the asset into which it is assimilated (*id.* at 13). That is not the case with a non-pro rata stock surrender. As previously stated, shares of stock represent an investment made by the shareholder in a corporation which entitles the shareholder to dividends, future appreciation, assets upon dissolution, and voting rights. Upon the disposition by surrender of those shares, that investment and its attendant rights are completely extinguished. For example, if the corporation were to liquidate the next day, the surrendering shareholder would receive a smaller distribution than if no shares had been surrendered. Thus, the surrender is a "final disposition" of the shareholder's investment and there is no "assimilation" of that investment. Far from being an "expenditure" that continues and enhances a shareholder's investment in the corporation, a surrender is a "loss" that terminates and diminishes that investment.[7]

Capital expenditure treatment is intended to correlate the cost of investment with the production of income. See *Commissioner v. Idaho Power Co.*, 418 U.S. at 11. Treat-

[7] Only to the extent, if any, that stock surrendered actually enhances the value of retained shares is it possible to consider a surrender an assimilation of investment in surrendered shares into investment in retained shares. The court of appeals' remand to the Tax Court takes this possibility into account.

ing non-pro rata stock surrenders as capital expenditures would have the opposite effect. The investment made by a shareholder in common stock entitles the shareholder to income consisting of dividends, future appreciation, and assets upon liquidation. Upon a non-pro rata surrender of stock, the right to that income as embodied in those shares is irrevocably lost. As the court explained in *Scherman v. Helvering*, 74 F.2d 742, 743 (2d Cir. 1935) (L. Hand, J.), "there would be larger dividends if the shares were kept, and a higher price if they were sold," and the time to reflect this loss "is now or never." Thus, the loss sustained on a non-pro rata stock surrender cannot be considered "related to the future and . . . appropriately allocated as part of the cost of acquiring an income-producing capital asset." *Commissioner v. Idaho Power Co.*, 418 U.S. at 11. Upon such a surrender, income-producing assets are lost, not acquired.

In sum, non-pro rata stock surrenders do not fit into the capital expenditure mold.[8] The government rests its argument to the contrary (Br. at 11-12) on this Court's oft-cited decision in *Deputy v. du Pont*, 308 U.S. 488 (1940). The Court there held that a taxpayer who owned stock in the du Pont Company was not entitled to deduct as an ordinary and necessary business expense payments made by the taxpayer that "proximately result not from the taxpayer's business but from the business of the du Pont Company" (308 U.S. at 494). In *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 594, *reh'g denied*, 320 U.S. 809 (1943), the Court applied the same rule, holding that a shareholder "could not conceivably

[8] The government attempts (Br. at 13-14) to support its capital expenditure theory by characterizing respondents' losses as voluntarily incurred. However, classification of transactions as voluntary or involuntary is irrelevant to proper analysis of the capital expenditure issue. In any event, the cases cited by the government on this point involve gifts and have no bearing on the issue presented here. *E.g., Mack v. Commissioner*, 45 B.T.A. 602 (1941), *aff'd*, 129 F.2d 598 (2d Cir. 1942).



deduct as a business expense the cost of . . . [another corporation's] business." These cases establish the "sound principle" that one taxpayer may not deduct the expenses of another taxpayer's business. 1 B. Bittker, *Federal Taxation of Income, Estates & Gifts* ¶ 20.1.4, at 20-10 to 20-11 (1981) (referring to *Deputy v. du Pont* as "the leading expense-of-another case"). Contrary to the government's assertion (Br. at 6, 12), those cases are solely premised on the ground that a shareholder may not deduct as an ordinary and necessary business expense under Section 162 an expense that does not relate to that shareholder's business. The cases do not address capital expenditures. In *Interstate*, for example, the government had made a capital expenditure argument, but the Court expressly reserved the issue, stating that "[i]n view of these conclusions, it is unnecessary to characterize the payment by petitioner as a capital expenditure" (319 U.S. at 594). Respondents make no claim that the stock surrenders here in issue constitute expenses or losses incurred in a trade or business, either of their own or of Travco. Respondents claim their deductions under Section 165(c)(2), not Section 162 or Section 165(c)(1). Thus, *du Pont* and *Interstate* are not on point. See *Schleppy v. Commissioner*, 601 F.2d at 197; *Frantz v. Commissioner*, 83 T.C. at 179.

The remaining cases cited by the government (Br. at 12-13, 25) are likewise inapposite. In each of them, shareholders paid amounts to third parties in satisfaction of expenses or liabilities of the corporation owed to those third parties. See *Rittenberg v. United States*, *supra* (shareholder paid corporation's rent expense); *South American Gold & Platinum Co. v. Commissioner*, *supra* (shareholder paid corporation's legal expense); *Eskimo Pie Corp. v. Commissioner*, *supra* (shareholder paid corporation's royalty expense); *Ihrig v. Commissioner*, *supra* (shareholder paid corporation's operating expenses). In those cases, the payments by the shareholders discharged specific corporate liabilities and, in turn, in-

creased corporate net worth. Thus, it was appropriate to treat the payments as additional investments by the shareholder in the corporation. The situation here is wholly different. By surrendering stock, respondents did not invest any additional "capital" in Travco, since the stock did not increase Travco's net worth or capital. Also, the stock surrenders did not entail the payment of any liability or obligation of Travco. Inasmuch as the stock surrenders neither provided Travco with any asset, nor relieved it of any liability, the cases relied upon by the government are off the mark. See *Estate of Steckel v. Commissioner*, 26 T.C. 600, 607 (1956), *aff'd*, 253 F.2d 267 (6th Cir. 1958) (per curiam) (distinguishing *Eskimo Pie* and *South American Gold* on this basis).

### C. Section 83 Is Inapplicable Outside the Area of Employee Compensation

The government seeks to bolster its characterization of the surrenders here in controversy as contributions to capital by reference to Section 83 of the Code (Br. at 26-29). That section deals with transfers of property in connection with the performance of services. The aspect of Section 83 that the government finds persuasive (Br. at 26) is Section 83(h), which provides that when property (for example, corporate stock) is transferred to a corporate employee for less than fair market value, the corporation may take a business expense deduction for the amount by which the employee is deemed to be compensated. The accompanying legislative history and interpretative Treasury Regulations indicate that in the situation where a shareholder transfers property to a corporate employee, the shareholder is to be treated as having made a contribution to the capital of the corporation which, in turn, is entitled to a business expense deduction for the compensation. See S. Rep. No. 552, 91st Cong., 1st Sess. 123-124 (1969); Treas. Reg. § 1.83-6(d).

These rules were necessary to avoid denial of a compensation deduction to both the shareholder and the corporation. Under the *du Pont* line of cases discussed above, the shareholder would not be entitled to a deduction for payment of the corporation's expense. And, the corporation would not be entitled to a deduction under Section 162 of the Code because it did not pay or incur the expense. To avoid this result, the Treasury Regulations recast the transaction as a payment of compensation from the corporation to the employee. Treas. Reg. § 1.83-6(d). This implements the decision of Congress "to tax the employee on the receipt of compensation and to allow the corporation a deduction for the payment thereof." *Tilford v. Commissioner*, 705 F.2d at 831, *citing* 75 T.C. at 156 (Simpson, J., dissenting). In the recast transaction, it is the shareholder's payment of the corporation's compensation expense that gives rise to the nondeductible capital contribution to the corporation. See, *e.g.*, *Rittenberg v. United States*, *supra*; *Eskimo Pie Corp. v. Commissioner*, *supra*.[9]

Section 83 cannot fairly be read as prescribing or requiring disallowance of an otherwise deductible loss in circumstances not involving the payment of employee compensation. As the government itself acknowledges

---

[9] The government poses an example (Br. at 28-29) in which it purports to illustrate that our position is inconsistent with Section 83. Under one case posited in the example, a shareholder compensates a shareholder/employee by transferring corporate stock directly to that shareholder/employee. As discussed above, Section 83 applies to such a transfer, allowing the corporation a deduction for the compensation expense and providing that the shareholder's payment of that expense is a contribution to capital. Under the second case in the example, the shareholder compensates the shareholder/employee indirectly through a surrender of stock to the corporation. The government assumes that Section 83 would not apply in this latter case. We disagree since, in this case as well as in the former, there has been a transfer of property in connection with the performance of services. Hence, our position is in no way inconsistent with Section 83. In any event, the government's example is irrelevant to disposition of the issue presented here, which has nothing to do with employee compensation.

(Br. at 28 n.13), "[i]n drafting Section 83, Congress was attempting to deal with all relevant aspects of a particular issue—transfers of restricted stock to employees as compensation. . . . Congress simply had no occasion to consider stock surrenders [such as those involved here] that are unconnected to employee compensation and that are made to the corporation rather than to its employees."

## III. THE GOVERNMENT'S REMAINING ARGUMENTS ARE WITHOUT MERIT

As demonstrated above, under the provisions of the statute and Treasury Regulations that apply to the facts of this case, respondents are entitled to deduct the losses in question. Perhaps recognizing the weakness of its position under those provisions, the government asserts (Br. at 29) that to allow these losses would create tension with other provisions of the Code. History itself teaches otherwise.

For a period of 50 years, beginning in 1929, the Board of Tax Appeals and the Tax Court,[10] other trial

[10] *Wright v. Commissioner*, 18 B.T.A. 471 (1929), *modified on another issue*, 47 F.2d 871 (7th Cir. 1931); *Burdick v. Commissioner*, 20 B.T.A. 742 (1930), *aff'd*, 59 F.2d 395 (3d Cir. 1932); *City Builders Finance Co. v. Commissioner*, 21 B.T.A. 800 (1930); *Clement v. Commissioner*, 30 B.T.A. 757 (1934); *Miller v. Commissioner*, 45 B.T.A. 292 (1941), *acq.*, 1941-2 C.B. 9, *acq. withdrawn & nonacq. substituted*, 1977-1 C.B. 2; *Budd Int'l Corp. v. Commissioner*, 45 B.T.A. 737 (1941), *acq.*, 1942-2 C.B. 3, *acq. withdrawn & nonacq. substituted*, 1977-1 C.B. 2, *rev'd on other grounds*, 143 F.2d 784 (3d Cir. 1944), *cert. denied*, 323 U.S. 802 (1945); *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947); *Payne Hous. Corp. v. Commissioner*, 13 T.C.M. (CCH) 603 (1954); *Duell v. Commissioner*, 19 T.C.M. (CCH) 1381 (1960); *Downer v. Commissioner*, 48 T.C. 86 (1967); *Smith v. Commissioner*, 66 T.C. 622 (1976), *rev'd sub nom. Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979); *Tilford v. Commissioner*, 75 T.C. 134 (1980), *rev'd*, 705 F.2d 828 (6th Cir.), *cert. denied*, 464 U.S. 992 (1983). These cases, which consider both surrenders to the issuing to the corporation and surrenders to third parties, generally are cited together. *E.g.*, *Frantz v. Commissioner*, 784 F.2d at 122.



courts,[11] and, excluding the Sixth Circuit below, three other courts of appeals,[12] uniformly held that a shareholder's non-pro rata surrender or transfer of stock results in an immediate loss. The Internal Revenue Service acquiesced in two of the Board of Tax Appeals decisions for approximately 35 years,[13] not withdrawing its acquiescences until 1977 (1977-1 C.B. 2), after the dates of the stock surrenders here in issue.[14] The Commissioner's

[11] *Berner v. United States*, 282 F.2d 720 (Ct. Cl. 1960); *Northwest Motor Servs. Co. v. United States*, 1960-2 U.S. Tax Cas. (CCH) ¶ 9488 (D.N.D. 1960); *Kress v. Stanton*, 98 F. Supp. 470 (W.D. Pa. 1951), *aff'd*, 196 F.2d 499 (3d Cir. 1952) (per curiam); *Peabody Coal Co. v. United States*, 8 F. Supp. 845 (Ct. Cl. 1934).

[12] *Kress v. Stanton*, *supra* (Third Circuit); *Scherman v. Helvering*, 74 F.2d 742 (2d Cir. 1935); *Burdick v. Commissioner*, *supra* (Third Circuit); *Wright v. Commissioner*, *supra* (Seventh Circuit). The government states (Br. at 18) that "[a]part from the court of appeals below, every court of appeals that has considered the question has held that non-pro rata stock surrenders do not give rise to an immediate loss . . . ." This statement ignores the cited cases, which involve stock transfers to employees. See *Frantz v. Commissioner*, 83 T.C. at 191 n.11 (Parker, J., dissenting).

[13] *Miller v. Commissioner*, 45 B.T.A. 292 (1941), *acq.*, 1941-2 C.B. 9; *Budd Int'l Corp. v. Commissioner*, 45 B.T.A. 737 (1941), *acq.*, 1942-2 C.B. 3. In its Cumulative Bulletins, the Internal Revenue Service states that "acquiescences in adverse decisions shall be relied on by Revenue officers and others concerned as conclusions of the Service . . . ." *E.g.*, 1976-1 C.B. 1.

[14] Moreover, prior to withdrawing its acquiescences, the Internal Revenue Service expressly conceded the issue in two court decisions. In *Payne Hous. Corp. v. Commissioner*, 13 T.C.M. (CCH) at 606, the court stated: "Since petitioner surrendered part of its stock to Payne Co. to improve the financial condition of Payne Co., it may take a deduction for a loss. *See Estate of William H. Foster*, 9 T.C. 930, 934, and cases cited therein. Respondent does not contend otherwise." In *Budd Int'l Corp. v. Commissioner*, 45 B.T.A. at 755-56, the court stated that "the Commissioner has held that the petitioner sustained a loss" upon the surrender of stock to the

35-year acquiescence is noteworthy for being "a significant addition to the already convincing array of authority" in support of respondents' position. *Fribourg Nav. Co. v. Commissioner*, 383 U.S. 272, 281 (1966). More importantly, it indicates that for a lengthy period, the Internal Revenue Service found no tension between that array of authority and the various other Code provisions that the government now seeks to invoke.

Similarly, Congress did not perceive any tension with other provisions of the Code. From 1929 to 1979, Congress amended the Internal Revenue Code on numerous occasions to change the treatment of various transactions between corporations and their shareholders. The changes made were both far-reaching and intricate.[15] Yet Congress did not change what was until 1979 the established rule that losses on non-pro rata surrenders of stock are immediately deductible. Given this history, that rule should be "deemed to have received Congressional approval." *Fribourg Nav. Co. v. Commissioner*, 383 U.S. at 283.

As for the tax-avoidance possibilities that the government conjures up, it is sufficient to point out that they did not arise in the past and that they are not present in this case. The Tax Court found (Pet. App. 28a) that the stock surrenders here in issue had the sound business purposes of improving Travco's financial position, preserving its business, and increasing its attractiveness to

---

corporation. The court rejected the Commissioner's argument that the character of the loss was capital rather than ordinary. But see Rev. Rul. 69-368, 1969-2 C.B. 27 (shareholder's transfer of stock to corporation, subsequently used to compensate employees, stated to be contribution to capital).

[15] A few of these changes are the enactment of Internal Revenue Code Sections 302 ("bailouts" of earnings and profits), 304 ("bailouts" through affiliated corporations), 305 (stock dividends), 306 (preferred stock "bailouts"), and 341 ("collapsible" corporations).



outside investors. The court went on to hold (Pet. App. 32a) that the surrenders were not primarily tax motivated, and the government does not challenge that determination (Br. at 36 n.20). Further, to the extent that tax-avoidance problems may arise in the future, the government is amply equipped to deal with them. The government's concerns about possible tax avoidance and the consequent effect on the revenues thus are vastly overstated.

### A. Neither Section 302 Nor Its "Principles" Guide Decision in This Case

Section 302 is designed to prevent the use of exchange transactions to "bail out" corporate earnings to shareholders as capital gains rather than as ordinary dividend income. It accomplishes this objective through an elaborate series of rules that determine whether a distribution from a corporation in redemption of its stock should be treated as having been made in a sale or exchange, typically resulting in capital gain or loss, or as a dividend, usually taxable as ordinary income.[16] Under Section 302, a distribution in redemption is treated as having been made in a sale or exchange if the redemption results in a "meaningful" reduction in the shareholder's percentage interest in the corporation (see *United States v. Davis*, 397 U.S. 301, *reh'g denied*, 397 U.S. 1071 (1970)), if it is "substantially disproportionate," or if it is in "complete redemption" of the shareholder's interest.[17] If the redemption does not satisfy any of these tests, the distribution is treated as a dividend, rather than as having been made in exchange for the stock redeemed, and the

---

[16] In the discussion that follows, the statement that a distribution will be treated as a "dividend" is predicated on the assumption that the distributing corporation's earnings and profits are sufficient to cover the amount of the distribution.

[17] We have no disagreement with the government's explanation (Br. at 30 n.14) of the meaning of these various terms in the context of Section 302.

shareholder's basis in the redeemed stock is added to his basis in his retained shares.

As we understand the government's argument, it is, first, that if respondents' shares had been redeemed rather than surrendered, the distribution in the redemption—involving a reduction in respondents' combined percentage interest from 72.5 percent to 68.5 percent—would have been treated as a dividend under Section 302. Second, the government says, that in such a situation, the redemption would have been divided into two parts, the first being the distribution, and the second being a contribution to capital of the shares redeemed. Finally, the government points out that Section 302 would in fact have applied if only respondents had received a penny or peppercorn of consideration instead of simply surrendering their shares. For these reasons, the government states (Br. at 31) that even though Section 302 admittedly does not apply, its principles "strongly indicate" the proper treatment of stock surrenders. There is much that is wrong with the government's argument.

First, it is extraordinary for the government to ask this Court to decide a case by reference to tax policy emanating from an anti-bailout provision of the Code that, on its face, has no application to the case. The provisions of the Code that do apply—Sections 165(a) and (c)(2) and 1001(a)—embody the tax policy that a deduction is to be allowed when a taxpayer disposes of property and sustains a loss. That is what occurred here. If the government wishes to have rules like those of Section 302 applied to surrenders of stock, it should ask the Congress to apply them.

Second, the government is incorrect in stating that, in the case of a distribution in redemption that is treated as a dividend, the stock redeemed is considered to have been contributed to capital. A redemption does not involve a contribution to capital. To the contrary, a redemption effectuates a distribution of capital, and this



is so irrespective of whether the distribution in redemption is characterized as having been made in an exchange or as a dividend.[18]

It is true, as the government points out, that the tax treatment of respondents' transactions would have been different if they had received consideration in an exchange. But this should not be surprising. The tax consequences of numerous transactions differ radically depending upon whether consideration is received in a sale or exchange. See, *e.g.*, *Commonwealth, Inc. v. Commissioner*, 36 B.T.A. 850 (1937) (transfer of property for no consideration is an abandonment that gives rise to ordinary rather than capital loss); *Beck v. Commissioner*, 8 T.C.M. (CCH) 126 (1949), *aff'd*, 179 F.2d 688 (7th Cir. 1950) (transfer of property for $100 of considera-

---

[18] As noted above, if a distribution in redemption does not satisfy any of the Section 302 tests for exchange treatment, the distribution is treated as a dividend rather than as having been made in exchange for stock. Section 302, being an anti-bailout provision, thus focuses exclusively on the treatment accorded to the distribution made to the shareholder by the corporation. When the distribution in redemption is not treated as having been made in an exchange, Section 302 fails to specify the treatment to be accorded to the shareholder's redeemed shares. The controlling Treasury Regulation provides that in such event "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Treas. Reg. § 1.302-2(c). Under this provision, the basis of the redeemed shares is transferred to other, remaining shares held by the surrendering shareholder or by a related shareholder. This basis adjustment is designed so that, upon a subsequent sale or other disposition of his remaining shares, the redeeming shareholder will be treated the same as if only a dividend had been distributed previously, even though some shares were redeemed in the disregarded "exchange." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholder* ¶ 9.62 (4th ed. 1979). The rule provided by the regulation thus calls only for a transfer of basis. It says nothing about a contribution to capital. See *United States v. Davis*, 397 U.S. at 308 n.9. The government's contention that Section 302 contains a contribution-to-capital component is spun from whole cloth.

tion is a sale that gives rise to capital rather than ordinary loss). The government is also correct (Br. at 31) that distribution of a penny or peppercorn of consideration might have altered the tax treatment of the transactions here in issue. But again, it is hardly unusual under the Internal Revenue Code for major tax swings to be controlled by the most modest sums, and taxpayers frequently are disadvantaged by those swings. For example, during the years in issue here, if a taxpayer missed an estimated tax "safe harbor" payment by even one cent, the taxpayer was subject to penalty not on the penny, but on the full amount of the estimated tax underpayment, no matter how great it was. See I.R.C. § 6654 (amended 1984). As this Court explained in a case where the government successfully contended that a taxpayer should not be relieved from what was perceived to be an inequity, the Internal Revenue Code was not "drafted with a singleminded devotion" to reducing arbitrariness. *United States v. Foster Lumber Co.*, 429 U.S. 32, 46 (1976). This, it seems to us, is a sufficient answer to the government's insistence here (Br. at 29) that the tax treatment of stock surrenders should "be reconciled with" redemption principles.[19]

That the government's position in this case is ultimately unprincipled is also readily apparent. The government seeks (Br. at 30-31) to restrict the Court's focus to surrenders that would not qualify for exchange treatment under the rules of Section 302. The implication is that if a surrender would qualify, the surrendering shareholder would be entitled to deduct the loss.[20] However,

---

[19] The government also states (Br. at 31) that "a stock surrender resembles a redemption for a zero dividend." Since the sine qua non of a redemption is the distribution of property by a corporation (see Section 317(b)), this statement is not meaningful.

[20] The courts of appeals in *Schleppy* and *Frantz* in fact took this type of approach. In *Schleppy*, the Fifth Circuit concluded (601 F.2d at 198) that the taxpayer's interest was "substantially the same" when it was reduced by surrender from 70.12 percent to



the government also tells the Court (Br. at 20 n.7) that it need not decide here the proper tax treatment of a surrender that would satisfy the sale-or-exchange standards of Section 302. The government nowhere explains how its possible willingness to allow a loss in the case of such a surrender can be reconciled with its theory that a stock surrender constitutes a capital contribution or other type of capital expenditure. Under that theory, a surrender that results in a four percent reduction in ownership interest should be treated similarly to one that results in a 40 percent reduction, and a surrender that results in a four percent reduction in ownership interest should be treated similarly whether made by 72.5 percent shareholders or by 7.25 percent shareholders.[21] By seeking to differentiate among surrenders, the government undercuts its own arguments and, in effect, admits that surrendering shareholders do sustain losses. As the Sixth Circuit explained in rejecting the government's position (Pet. App. 12a-13a), "[t]his reasoning addresses the size of the loss" and "implicitly recognizes" that a loss has occurred.

Under existing law, no basis exists for allowing losses resulting from some stock surrenders but not from others. Either stock surrenders result in losses, or they do

---

68.57 percent. It distinguished a situation in which a taxpayer owned "substantially less" after the surrender. The Second Circuit in *Frantz* similarly concluded (784 F.2d at 125) that "our holding in this case should not be construed as governing surrenders by a stockholder of more substantial equity interests."

[21] The discussion in the text examines stock surrenders from the standpoint of the surrendering shareholder. The same result obtains if surrenders are considered from the standpoint of the corporation. For example, surrenders of a specified number of shares should be treated similarly whether made by 72.5 percent shareholders or 7.25 percent shareholders. Stock surrenders simply do not increase a corporation's capital, regardless of the size of the surrendering shareholders' interest in the corporation prior to the surrender.

not. In the end, then, the government is asking this Court either to apply to stock surrenders a Code provision pertaining only to corporate distributions, or to construct a common law of stock surrenders. Under either approach, the Court would be required to make distinctions between one stock surrender and another without any statutory authority for doing so. The Court should decline the government's invitation to enter this thicket, particularly in view of the 50-year history of the rule that losses on stock surrenders are immediately deductible.

### B. Allowance of Immediate Loss Deductions Would Pose No Threat to Section 165(g)

Prior to 1938, worthless stock losses were deductible as ordinary losses under the predecessor of Section 165(c). In 1938, Congress changed this result by enacting the predecessor of Section 165(g). It provides, as a general rule, that losses realized when securities that are capital assets become worthless are to be treated as capital losses. Section 165(g) accomplishes this by treating worthlessness as a constructive sale or exchange. Congress prescribed this result based on its determination that it was appropriate to treat both losses incurred on actual sales and exchanges and losses incurred upon worthlessness as capital losses. See H.R. Rep. No. 1860, 75th Cong., 3d Sess. 18 (1938).

The government now maintains (Br. at 34) that allowing an immediate loss deduction upon the surrender of stock could enable future taxpayers "easily" to thwart Section 165(g) and thus lead to the de facto repeal of that provision.[22] The court of appeals properly rejected

[22] The government states (Br. at 32) that it is concerned in part because the court of appeals "apparently assumed" that the losses in issue here would be ordinary. That court did not merely assume that the losses would be ordinary, it expressly so held (Pet. App. 16a), as urged by respondents. Moreover, this treatment is required



this contention, noting (Pet. App. 14a) that the "traditional tax common law doctrines, such as substance over form, sham transaction, step transaction and the business purpose rule, are sufficient to prevent any abuses that arise." Only last Term, in a different context, the government made virtually the same argument, and this Court rejected it on virtually identical grounds, holding that the power of the Commissioner "to correct any such abuse is the complete practical answer to the Government's concern." *United States v. Hughes Properties, Inc.*, 106 S. Ct. 2092, 2099 (1986). In any event, where as here, no abuse exists and "the transaction is actually what it purports to be it must be accepted for its legal results." *Chamberlin v. Commissioner*, 207 F.2d at 470.

In substance, the government argues not against a judicial repeal of Section 165(g), but for the judicial enactment of a new section of the Internal Revenue Code. As mentioned above, prior to 1938, worthless stock losses were treated as ordinary losses under the ordinary loss rules of the predecessor of Section 165(c). In 1938, Congress determined that the ordinary loss rules should, as a general rule, not apply and that worthless stock losses should henceforth be treated as capital losses. Accordingly, Congress amended the statute to add the predecessor of Section 165(g). In this case, the government argues that losses incurred upon stock surrenders likewise should not be deductible under the ordinary loss rules of Section 165(c).[23] However, instead of asking Congress to enact a new Code provision, the government, in effect, asks this Court to do so. Clearly, if the Code

because, as the government elsewhere concedes (Br. at 21), the surrenders in issue were not sales or exchanges, and no provision of the Code deems them to be.

[23] Enactment of the predecessor of Section 165(g) did not disallow worthlessness losses, but recharacterized such losses as capital rather than ordinary. Here, the government seeks the more extreme result of total disallowance.

is to be so amended, "it should be done by appropriate legislation, not court decision." *Chamberlin v. Commissioner*, 207 F.2d at 472.

### C. The Court of Appeals' Method of Computing Respondents' Losses is Neither Unprecedented Nor Impractical

As its final argument, the government asserts (Br. at 36-38) that the court of appeals' decision that the measure of the loss is the basis of the surrendered shares less any increase in value of the retained shares is both unprecedented and impractical. In fact, it is neither.

Measuring the amount of actual loss sustained by a taxpayer is not unprecedented, but rather is expressly required by the Code. Section 165(b) and Treasury Regulations Section 1.165-1(c) provide that the amount of loss allowable as a deduction under Section 165(a) generally equals, and shall not exceed, the adjusted basis of the property. Section 165(a) provides that losses are deductible to the extent "not compensated for by insurance or otherwise." It is well settled that "[t]he term 'or otherwise' is broad enough to cover any form of offsetting benefit as well as actual recoupment." 7 J. Mertens, *Law of Federal Income Taxation* ¶ 28.07 (1986). This reflects the fact that if a taxpayer's "loss is made whole from some other source, then in actuality he has not sustained a loss." *Forward Communications Corp. v. United States*, 608 F.2d 485, 501 (Ct. Cl. 1979). Accordingly, when a non-pro rata stock surrender actually increases the value of the shares retained, courts have required that the amount of loss allowable be reduced by the amount of that increase in value. See, *e.g.*, *Duell v. Commissioner*, 19 T.C.M. (CCH) at 1385; *Miller v. Commissioner*, 45 B.T.A. at 299. If the surrender has no effect on the value of the retained shares, then the full amount of the loss is deductible. See, *e.g.*, *Smith v. Commissioner*, 66 T.C. at 650; *Budd Int'l Corp. v. Commissioner*, 45 B.T.A. at 756. Ample precedent thus exists for the decision of the court below.



As noted above, the fact that measurement of the amount of the loss may require valuation of respondents' remaining stock provides no support for the government. Value is undeterminable only in "rare and extraordinary cases." Treas. Reg. § 1.1001-1(a). The Internal Revenue Service itself has published rules governing the valuation of common stock, and the Tax Court is well equipped to perform that function on remand. See Rev. Rul. 59-60, 1959-1 C.B. 237. Thus, the government's concern over valuation is a strawman that should not prevent the allowance of deductions for the losses that respondents actually sustained.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

*Of Counsel:*
W. MERRITT JONES, JR.
MARK K. WILSON
HILL, LEWIS, ADAMS, GOODRICH & TAIT
100 Renaissance Center
Detroit, Michigan 48243

MATTHEW J. ZINN
(Counsel of Record)
SUSAN H. SERLING
J. WALKER JOHNSON
STEPTOE & JOHNSON
1330 Connecticut Ave., N.W.
Washington, D.C. 20036
(202) 429-6422
*Attorneys for Respondents*

March 1987

# APPENDIX

## APPENDIX

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arises from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100.

* * * *

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the

loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * *

TREASURY REGULATIONS ON INCOME TAX (26 C.F.R.):

SEC. 1.165-1. LOSSES.

(a) *Allowance of deduction.* Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder. For the disallowance of deductions for worthless securities issued by a political party, see § 1.271-1.

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) *Amount deductible.*

(1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by § 1.1011-1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction. To determine the allowable loss in the case of property acquired before March 1, 1913, see also paragraph (b) of § 1.1053-1.



(2) The amount of loss recognized upon the sale or exchange of property shall be determined for purposes of section 165(a) in accordance with § 1.1002-1.

(3) A loss from the sale or exchange of a capital asset shall be allowed as a deduction under section 165(a) but only to the extent allowed in section 1211 (relating to limitation on capital losses) and section 1212 (relating to capital loss carrybacks and carryovers), and in the regulations under those sections.

(4) In determining the amount of loss actually sustained for purposes of section 165(a), proper adjustment shall be made for any salvage value and for any insurance or other compensation received.

* * * *

# REPLY BRIEF

(6)

No. 86-511

Supreme Court, U.S.
FILED
APR 20 1987
JOSEPH F. SPANIOL, JR.
CLERK

# In the Supreme Court of the United States

OCTOBER TERM, 1986

---

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

---

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

---

## REPLY BRIEF FOR THE PETITIONER

---

CHARLES FRIED
*Solicitor General*
*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

1PP

## TABLE OF AUTHORITIES


| Cases: | Page |
|---|---|
| *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974) | 5 |
| *Deputy* v. *du Pont*, 308 U.S. 488 (1940) | 3, 4 |
| *Frantz* v. *Commissioner*, 784 F.2d 119 (2d Cir. 1986) | 15 |
| *Helvering* v. *Gowran*, 302 U.S. 238 (1937) | 8 |
| *Koshland* v. *Helvering*, 298 U.S. 441 (1936) | 8 |
| *Schleppy* v. *Commissioner*, 601 F.2d 196 (5th Cir. 1979) | 11 |
| *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979) | 11 |
| **Statutes and regulation:** | |
| Internal Revenue Code (26 U.S.C.): | |
| § 83 | 13, 14 |
| § 165(c)(2) | 5 |
| § 263 | 5 |
| § 302 | 14, 15, 16 |
| § 305 | 4, 9 |
| § 305(a) | 10 |
| § 305(b) | 10 |
| Treas. Reg. § 25.2511-1(h)(1) | 4 |
| **Miscellaneous:** | |
| H.R. Rep. 1337, 83d Cong., 2d Sess. (1954) | 10 |
| S. Rep. 91-552, 91st Cong., 1st Sess. (1969) | 13 |
| Wall St. J.: | |
| Jan. 2, 1986 | 12 |
| Jan. 21, 1986 | 12 |
| Mar. 28, 1986 | 12 |
| May 28, 1986 | 12 |

# In the Supreme Court of the United States

OCTOBER TERM, 1986

---

No. 86-511

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

PETER R. FINK ET UX.

---

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

---

## REPLY BRIEF FOR THE PETITIONER

---

1. The question in this case is whether a shareholder is entitled to claim an ordinary loss upon a non-pro-rata surrender of shares to his corporation. Respondents devote much of their brief to quarreling with our submission that the surrender is best viewed as a "contribution to capital," and we will discuss those objections in due course. At the outset, however, it is revealing to note that respondents make little effort to demonstrate affirmatively that the surrender should be treated as a loss. This approach is understandable. For whatever uncertainty there may be over exactly how to characterize the stock surrender here, it is quite clear that it cannot sensibly be characterized as a "loss."

a. In surrendering a portion of their shares to the corporation, respondents parted with something of value for no explicit consideration in return. Ordinarily, such an intentional parting with something of value might be thought to be a gift. A deliberate gift motivated by donative intent, of course, does not give rise to a loss, and making a gift does not entitle the donor to a tax deduction.

Respondents were careful, however, to dispel any suggestion that the stock surrender could be viewed as a gift to the corporation, or to minority shareholders, to the extent of the slight increase in their fractional interest. The letters accompanying the surrender of their shares stated that they were taking this step "in order to improve the financial condition of the company" (Stip. Exhs. 7-G, 8-H; see also Resp. Br. 3). Thus, respondents averred that their surrender was not motivated by a donative intent, but rather was designed to improve the corporation's business condition. But the existence of that business justification for the surrender provides no basis whatsoever for respondents to claim a loss. There exist only three possible beneficiaries of the improved corporate performance that respondents' surrender was designed to enhance—the corporation itself, respondents, and respondents' fellow shareholders. Regardless of who is thought to be the intended or actual beneficiary, established tax principles make it clear that allowance of an immediate loss deduction is not the correct tax treatment.

First, respondents themselves, as the dominant shareholders, derived the principal benefit from the improved health of the corporation because they retained a 68.5% equity interest in it. As we explained in our opening brief (at 10-14), expenditures made



to conserve or enhance the value of a taxpayer's shares are nondeductible capital expenditures. Thus, to the extent that respondents themselves benefited from the stock surrender they cannot possibly have suffered a loss.

Second, to the extent that respondents themselves did not benefit from the stock surrender, a plausible beneficiary would be the corporation, which, after all, received something for nothing. But if the benefit of the stock surrender is viewed as redounding to the corporation, there again can be no deductible loss. The transfer of property by a shareholder to his corporation for the corporation's benefit is the essence of a contribution to capital, which yields an adjustment to the basis of the shareholder's remaining shares but does not give rise to an immediately deductible loss. And even if characterizing the surrender as a "contribution to capital" is thought imprecise—a point we address below—there is no denying that respondents expended some of their assets on behalf of their corporation, which is an inherently capital expense. See *Deputy* v. *du Pont*, 308 U.S. 488 (1940). Thus, to the extent that the corporation itself benefited from the stock surrender, respondents cannot possibly have suffered a loss.

Third, if respondents are correct in asserting that neither they nor their corporation really benefited from the surrender, the beneficiaries must necessarily have been respondents' fellow shareholders. Those individuals did not surrender any shares, and the effect of the surrender was thus to increase their percentage interest in the corporation's assets from 27.5% to 31.5%. But the conferral of a benefit upon the minority shareholders would not entitle respondents to a loss deduction either. One can imagine various

reasons why respondents might have wanted to confer a benefit on those persons. Some of the minority shareholders were respondents' relatives (Pet. App. 30a) and thus were possible objects of respondents' bounty. Some of the minority shareholders may have been disgruntled because of the corporation's poor performance, and respondents may have desired to appease them or deter them from bringing a derivative suit. In either event, of course, respondents' action would not entitle them to a loss deduction. In the first case, the surrender might be a nondeductible gift. See Treas. Reg. § 25.2511-1(h)(1). In the second case, it would be a nondeductible payment on behalf of the corporation. See *Deputy* v. *du Pont*, *supra*.

The fact that respondents realized no loss on the stock surrender is highlighted if one recasts the transaction slightly. Suppose that, instead of employing a non-pro-rata stock *surrender* to reduce their ownership of the corporation by four percentage points, respondents had caused the corporation to issue a non-pro-rata stock *dividend* to the minority shareholders, so as to increase the latter's interest in the corporation by the identical margin.[1] Under either scenario, the bottom line would be exactly the same: respondents' interest would decline from 72.5% to 68.5%, and the minority shareholders' interest would go up from 27.5% to 31.5%. Respondents could not possibly claim a loss deduction if this end result were accomplished by the stock-dividend route. This strongly suggests that they did not suffer any recognizable

[1] Section 305 of the Code would govern whether the minority shareholders would have to recognize income upon receipt of such a stock dividend. We discuss that provision at note 5, *infra*.



loss under the scenario that they did use, which differs from the stock-dividend scenario only in that the same ownership interests in the corporation were represented by fewer pieces of paper.

In short, when a shareholder voluntarily transfers something of value to his corporation in exchange for the anticipated benefit of improving the company's financial situation, the shareholder has not realized any loss. This is so regardless of whether one views the shareholder, his fellow shareholders, or the corporation—either separately or in combination—as the true beneficiaries of the transaction. A shareholder obviously suffers no loss when he benefits himself or his corporation, and respondents have advanced no theory under which they could be thought to have suffered a loss by benefiting the minority shareholders. The surrender here was not a "loss" in any sense of the word; it was a deliberate expenditure designed to benefit the corporation and its various shareholders and as such was nondeductible.[2]

b. Respondents' affirmative argument that the stock surrender here should be viewed as a loss (Br.

[2] Respondents object (Br. 14-15, 24 n.8) to consideration of their motivation for the surrender in determining the appropriate tax treatment. But it ill behooves respondents to argue that their motivation should be ignored, for it is they who injected the question of motive into this case; if they lacked the business purpose that they assert, their surrender might well be viewed as a gift, and in that event they would clearly not be entitled to claim a loss. In any event, there is no merit to respondents' suggestion that motive generally should play no role in this type of determination. See I.R.C. § 165(c)(2). Moreover, the determination of what constitutes a capital expenditure under I.R.C. § 263 plainly contemplates some consideration of the taxpayer's motive in making the expenditure. See generally *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974).

12-13) is both brief and unconvincing. Respondents assert that a non-pro-rata stock surrender must give rise to a loss because it causes a percentage reduction in the surrendering shareholder's interest in the corporation, which may result ultimately in the loss of certain benefits, such as future dividends or a share of the corporation's assets in the event of a solvent liquidation. But there is little basis for the view that a percentage decrease in a shareholder's interest in a corporation is itself an event that gives rise to a loss.[3] As noted above, if the corporation here had declared a non-pro-rata stock dividend to the minority shareholders, respondents' percentage interest in the corporation would have been reduced, but they would have had no colorable claim to an immediate loss deduction. And, as noted in our opening brief (at 29), if respondents had transferred a smaller number of their own shares directly to the minority shareholders, respondents' percentage ownership would also have been reduced, but they again would have had no colorable claim to an immediate loss deduction.

Moreover, the adverse effects that respondents cite are all *future* events whose tax consequences inevitably will be taken into account when those events occur. To the extent respondents receive smaller dividends in the future or a smaller share of the

[3] It should be noted that the amount of the "loss" respondents seek to deduct bears no relation to the amount of the "loss" allegedly occasioned by the reduction in their percentage interest in the corporation. The loss they seek to deduct is derived from their basis in the surrendered shares, and it does not depend at all on the extent to which they may be predicted to lose future dividends or a share of corporate assets upon dissolution.



assets upon liquidation, they will have commensurately less taxable income or, perhaps, a greater ultimate capital loss. There is no need to give them a loss now, upon occurrence of the event occasioning the reduction in their ownership interest, in order to recognize the loss that respondents may suffer in the future.

More generally, the fact that respondents have "given something up" by surrendering a portion of their shares clearly provides no support for their claim for recognition of an immediate loss. Respondents concede (Br. 19) that a shareholder's contribution of cash or other property to his corporation, even if non-pro-rata, does not generate an immediate loss. In those situations, however, the shareholder has given something up just as surely as he has done in the case of a stock surrender. A shareholder's contribution of cash or property to his corporation, like a surrender of shares, also results in an enhancement of the minority shareholders' interests by increasing the value of each corporate share; but this circumstance does not entitle the contributing shareholder to claim a loss. In short, whether the shareholder contributes stock or other property, there is no need to allow an immediate loss deduction in order to take account of what he has done. Rather, any potential loss resulting from the contribution is reflected in an adjustment to the basis of the shareholder's remaining shares, and it can be deducted if and when the loss is actually realized through a taxable disposition of that stock.[4]

[4] Respondents point out (Br. 23) that if Travco had been liquidated the day after the surrender, they would have received a smaller distribution than if no shares had been surrendered. But this potential "loss" upon liquidation is no different from that occasioned by a contribution of other

c. Respondents also rely (Br. 7, 13, 22) on an analogy drawn from this Court's decision in *Koshland* v. *Helvering*, 298 U.S. 441 (1936). The Court there reasoned that shareholders whose percentage interest increases because of a non-pro-rata stock dividend receive income in the constitutional sense, although it noted that the revenue act did not render that income recognizable. See also *Helvering* v. *Gowran*, 302 U.S. 238 (1937). If a non-pro-rata stock dividend yields income, respondents reason, a non-pro-rata stock surrender must yield a loss.

This reasoning is seriouly flawed. First, there is no reason why the tax treatment of a shareholder's

---

property to a corporation, and there is no reason why the surrender itself should give rise to an immediately deductible loss. This similarity may be demonstrated by an example. Suppose that a shareholder holds a 75% interest in a corporation that has a liquidation value of $100,000, and that the shareholder also has $20,000 in the bank. To aid the corporation's financial position, the shareholder surrenders a portion of his shares, reducing his percentage interest to 70%. Respondents would say that the shareholder suffers a loss by reason of the surrender on the theory that the proceeds that would accrue to him on liquidation of the corporation would thereby be reduced by 5%, or $5,000. But suppose instead that the shareholder contributes his $20,000 to the corporation. If the corporation were then liquidated, he would receive a distribution of $90,000 (75% of $120,000). In both cases, he will end up with the same $90,000 in the bank, and the minority shareholders will end up with $30,000. In both cases, the shareholder can be said to have "given up" $5,000 by reason of the contribution, in the latter case because the contribution gives the minority shareholders a 25% interest in what previously was his own $20,000. But it is undisputed that the shareholder cannot recognize any loss upon contributing the $20,000 in cash, notwithstanding the $5,000 decline in his potential liquidation proceeds. There is no reason why the result should be different when he surrenders stock.



receipt of a stock dividend *from* the corporation should have any particular relevance to the tax treatment of a shareholder's contribution of stock *to* the corporation. The receipt of property by a taxpayer is ordinarily a taxable event, whereas a shareholder's contribution of property to his corporation is ordinarily in the nature of an investment that has no immediate tax consequences. The simplest example is cash. A cash distribution from the corporation to its shareholder is recognized as income, but a cash contribution from a shareholder to the corporation is a contribution to capital that does not give rise to an immediate loss.

Moreover, the so-called "proportional interest doctrine" (Resp. Br. 15) that respondents seek to derive from *Koshland* v. *Helvering* seems to point in a direction that is not particularly helpful to them. The Court there did not hold that a non-pro-rata stock dividend results in the recognition of a loss by the shareholders whose interest goes *down*. Rather, it held that such a dividend results in the receipt of income by the shareholders whose interest goes *up*. In the instant case, the consequence of respondents' stock surrender was that their interest went down and that the minority shareholders' interest went up. It is hard to see how *Koshland* supports respondents' ability to claim a loss in these circumstances.[5]

---

[5] In any event, the premise of respondents' argument by reverse analogy has been undermined by Congress. In the 1954 Code, Congress provided special statutory treatment of non-pro-rata stock dividends in Section 305 of the Code. The House Report on the 1954 provision specifically noted that "[a]s long as a shareholder's interest remains in corporate solution, there is no appropriate occasion for the imposition of a tax." The Committee added that generally no tax should be imposed upon the distribution of stock divi-

2. In our opening brief (at 10-29), we explained that the surrender here is best characterized as a "contribution to capital," just the same as the contribution of any other form of property by a shareholder to his corporation would be characterized. Respondents rely on "two critical distinctions" (Br. 20) to justify their contention that the general rule governing contributions to capital does not apply when the contributed property is stock in the corporation.

First, respondents assert (Br. 22) that non-pro-rata stock surrenders must be treated differently from contributions of other forms of property because the latter do not entail a change in a shareholder's percentage interest in the corporation. But this assertion completely begs the question. There is no dispute that this case is slightly different on its facts than the usual contribution-to-capital case because the property contributed here was stock in the corporation. Were it not for that difference, this case would indisputably be controlled by respondents' concession (Br. 19) that a contribution of any other

---

dends, "without regard to whether or not a particular shareholder's proportionate interest in the continuing business has varied." H.R. Rep. 1337, 83d Cong., 2d Sess. 35 (1954). The 1954 Code thus sought to eliminate the "problems" that Congress perceived in the line of cases emanating from *Koshland* that made non-pro-rata stock dividends generally taxable. H.R. Rep. 1337, *supra*, at A81. Although Congress has enacted several exceptions to Section 305(a) since 1954 to tax certain kinds of stock dividends—including dividends where the shareholder receives or has the option of receiving cash or property instead of stock (see Section 305(b))—it has retained the "general rule" of Section 305(a) that "gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock."



form of property does not give rise to an immediate loss deduction. The question here is whether that slight difference is of any significance. To say that respondents' surrender yielded a change in their percentage interest in the corporation is simply another way of stating that the surrendered property was stock. But respondents do not explain why this particular factual distinction should lead to a difference in tax treatment. As we noted above (pages 4-5, *supra*), a non-pro-rata stock dividend to the minority shareholders would also have yielded a change in respondents' percentage interest in the corporation, yet that event indisputably would not be an appropriate occasion for respondents' recognition of a loss. Moreover, even if a substantial change in ownership of the corporation could be relevant, respondents are surely placing undue reliance on that factor here, inasmuch as "the diminution in [their] corporate control and equity interest [was] so minute as to be illusory" (Pet. App. 20a (Joiner, J., dissenting)).

Respondents' other basis for distinction is their argument that the surrender here, unlike the contribution of cash or other property, cannot be treated as a contribution to capital because it did not technically increase the "capital" or net worth of the corporation. As we explained in our opening brief (at 23-25), the concept of a "contribution to capital" for tax purposes is not limited by accounting rules that concern the treatment of various transactions on the corporation's balance sheet. See *Schleppy* v. *Commissioner*, 601 F.2d 196, 197 n.2 (5th Cir. 1979); compare *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542-544 (1979). There are many transactions—such as a shareholder's surrender of bonds, forgiveness of other corporate indebtedness, or payment of a

corporate expense—that are not contributions to "capital" in an accounting sense in that they do not increase the stated "capital" or the assets of the corporation. Yet these transactions are undeniably treated for tax purposes as "contributions to capital," with the shareholder receiving a basis adjustment rather than a loss deduction. The point is that respondents, in surrendering their stock, transferred valuable property to their corporation for the purpose of aiding the corporation. Because the corporation benefited thereby, respondents may properly be said to have "contributed to its capital," even though the contributed treasury stock was not technically an "asset" in accounting terminology.[6] In any event, the accounting terminology employed by the corporation is manifestly irrelevant from respondents' perspective, which is the relevant one when it is their tax consequences that are at issue.

---

[6] Indeed, respondents' idea that a corporation's own stock is not worth anything to it sounds rather odd at a time when this Nation's corporations are spending billions of dollars to buy back their stock on the open market. During 1985, for example, four major oil companies spent $13 billion to buy back their shares. Wall St. J., Jan. 2, 1986, at 6B, col. 2. In May 1986, IBM announced that it would spend $1.47 billion to buy back its stock, stating that the shares were "attractive at current prices" and represented a "good long-term investment." Wall St. J., May 28, 1986, at 4, col. 1. One of the reasons cited for such stock buy-backs was the need to acquire shares for use in employee pension and profit-sharing plans. See, *e.g.*, Wall St. J., May 28, 1986, at 5, col. 1 (IBM); Wall St. J., Mar. 28, 1986, at 6, col. 2 (Martin Marietta Corp.); Wall St. J., Jan. 21, 1986, at 6, col. 6 (General Motors Corp.). These actions by the Nation's leading corporations suggest that *they* regard their stock as valuable property, in part because it can be used to discharge various corporate liabilities. If IBM's shareholders had decided to save it the expense of buying its stock on the open market by contributing their shares voluntarily, those individuals would surely be said to have made a "contribution to its capital." Common sense dictates the same conclusion here.



In fact, as we explained in our opening brief (at 26-29), Congress already has indicated that it is appropriate to treat a non-pro-rata stock surrender as a "contribution to capital" for tax purposes. In enacting Section 83 of the Code in 1969, Congress stated that a shareholder's "bargain sale" of stock to a corporate employee, when designed to compensate that employee, should be treated as "a capital contribution" by the shareholder. S. Rep. 91-552, 91st Cong., 1st Sess. 123-124 (1969). Respondents concede the correctness of this treatment (Br. 26-27). Respondents also seem to concede that a shareholder would make a "contribution to capital" if, instead of transferring stock directly to the employee, he surrendered stock to the corporation, which in turn transferred the stock as compensation to the employee (Br. 27 n.9). Respondents thus appear to accept the principle that a stock surrender is properly regarded as a "contribution to capital" when the corporation subsequently uses the stock to discharge a particular sort of corporate liability—a liability to compensate its employees. It is hard to see why the same stock surrender would cease to be a "contribution to capital" if the corporation chose to use the stock for some other corporate purpose.

It is therefore apparent that Congress did not regard the technical accounting difference, with respect to a change in the corporation's "assets" or net worth, that exists when the property contributed to a corporation is its own stock, as an impediment to

characterizing a stock surrender as a "contribution to capital." Respondents simply do not explain why a surrender of stock can be treated as a "contribution to capital" in the employee-compensation context, yet is inherently incapable of being a "contribution to capital" in any other context. If the "two critical distinctions" (Resp. Br. 20) that respondents identify between contributions of stock and contributions of other forms of property have any significance, they would equally require that the shareholder be entitled to take an immediate loss when he surrenders stock to the corporation for the payment of employee compensation. But Section 83 shows that that is not the law.

Ultimately, respondents' objections to our position seem to boil down to semantics. Because the instant stock surrenders arguably did not increase Travco's "capital" in a technical accounting sense, respondents maintain that they cannot be treated as "contributions to capital." But semantics does not govern the proper tax treatment of these transactions. In our opening brief (at 30), we noted that Section 302 of the Code provides in the stock-redemption context that the basis of the redeemed shares is to be added to the basis of the retained shares when the distribution is taxed as a dividend. Respondents object that this treatment does not mean that the shares surrendered in the redemption are "contributed to capital," even though the addition of those shares' basis to the basis of the retained shares is the same tax result that would attend a contribution to capital. Rather, respondents say, Section 302 entails merely a "transfer of basis" (Br. 33 n.18). But perhaps the same is true here. If, as respondents contend, there is something unsatisfying about labelling



a stock surrender a "contribution to capital," we are content to say that a stock surrender requires a "transfer of basis." The label is unimportant; the tax consequences are important. Whatever label is used, the point is that respondents' stock surrender did not give rise to an immediate loss. The correct tax treatment is to reallocate respondents' basis in the surrendered shares to the shares that they retained. The impact of the surrender on respondents' tax liabilities will thus be recognized upon the disposition of those remaining shares.

3. Respondents accuse us of being "unprincipled" (Br. 34-36) in assertedly implying that a stock surrender that would qualify for "exchange" treatment if effected as a redemption under Section 302—*e.g.*, a "substantially disproportionate" transfer that brought the surrendering shareholder's interest below 50%—would give rise to a loss, whereas other types of stock surrenders would not. The premise of this accusation is unfounded, for we have not implied that such a surrender would give rise to a loss. To the contrary, we believe that *any* stock surrender fits the mold of a contribution to capital. We did note in our opening brief that a surrender that caused the surrendering shareholders to lose control of the corporation might present a more difficult question than the one presented here, where respondents' ownership interest declined only from 72.5% to 68.5%. The Second Circuit majority in *Frantz* v. *Commissioner*, 784 F.2d 119, 125 (1986), made the same point. To take an extreme example, the tax consequence of a "capital contribution" or "transfer of basis" would not seem entirely satisfactory, as a practical matter, in the case of a shareholder who surrendered 99,999 of his 100,000 shares.

In our opening brief (at 20 n.7), we noted only that it is unnecessary for the Court to concern itself with this more difficult situation because respondents' surrender occasioned only a miniscule change in their ownership interest—the sort of surrender that both the majority and concurring judges in *Frantz* agreed could not give rise to a deductible loss. There is every reason to believe, moreover, that the more difficult situation that respondents emphasize is a purely hypothetical one that will occur infrequently in practice. The reported cases indicate that rarely, if ever, has a shareholder surrendered enough shares to destroy his majority interest in a corporation; economic self-interest would appear to counsel strongly against such action. And even if a shareholder were inclined to surrender enough shares to cause loss of corporate control, he could easily structure his transfer as a redemption by having the corporation pay token consideration, thereby entitling him to "exchange" treatment—and thus to a capital loss if his investment has been a poor one—under the safe harbor provisions of Section 302. Accordingly, concern over the proper treatment of the unlikely hypothetical situation posited by respondents should not affect the Court's disposition of the quite different question presented here.

For the foregoing reasons, and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

CHARLES FRIED
*Solicitor General*

APRIL 1987

☆ U. S. GOVERNMENT PRINTING OFFICE: 1987 181483 40305

# AMICUS CURIAE

# BRIEF

No. 86-511

Supreme Court, U.S.
FILED
MAR 20 1987
JOSEPH F. SPANIOL, JR.

In The

# Supreme Court of the United States

October Term, 1986

COMMISSIONER OF INTERNAL REVENUE,

*Petitioner,*

*vs.*

PETER R. FINK, *et ux.*,

*On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit*

## BRIEF FOR AMICUS CURIAE

PATRICK J. CARR
*Attorney for Amicus Curiae*
52 Vanderbilt Avenue
New York, New York 10017
(212) 557-9890

5392
Lutz Appellate Printers, Inc. • NJ (201) 257-6850 • (800) 3 APPEAL • NY (212) 840-4640 • MA (617) 542-1114 DC (202) 783-7288 • PA (215) 925-6500 • USA (800) 5 APPEAL

## QUESTION PRESENTED

Whether a section of the Internal Revenue Code may be judicially disregarded in spite of its demonstrated applicability and plain meaning developed through 50 years of consistent judicial interpretation, administrative application and legislative reenactment.

## TABLE OF CONTENTS


| | Page |
|---|---|
| Question Presented | i |
| Table of Contents | ii |
| Table of Citations | ii |
| Interest of the *Amicus Curiae* | 1 |
| Argument | 2 |
| Conclusion | 7 |


## TABLE OF CITATIONS

**Cases Cited:**


Budd International Corp. v. Commissioner, 45 B.T.A. 737 (1941), acq. 1942-2 C.B. 3, nonacq. 1977-1 C.B. 2, rev'd on other issues, 143 F. 2d 784 (3d Cir. 1944), cert. denied, 323 U.S. 802 (1945) ..... 4

Estate of Foster v. Commissioner, 9 T.C. 930 (1947), acq. 1948-1 C.B. 2 .....4, 6

Fink v. Commissioner, 789 F. 2d 427 (6th Cir. 1986) .....2, 3, 4, 5, 6, 7

Florida National Guard v. Federal Labor Relations Authority, 699 F. 2d 1082 (11th Cir.), cert. denied, 464 S. Ct. 1007 (1983) ..... 7




*Contents*


| | Page |
|---|---|
| Frantz v. Commissioner, 83 T.C. 162 (1984), aff'd, 784 F. 2d 119 (2d Cir. 1986) | 1, 2, 3, 4, 5, 6, 7 |
| J. K. Downer v. Commissioner, 48 T.C. 86 (1967) | 2, 3, 5 |
| Julius Miller v. Commissioner, 45 B.T.A. 292 (1941), acq. 1941-2 C.B. 9, nonacq. 1977-1 C.B. 2 | 4 |
| Schleppy v. Commissioner, 601 F. 2d 196 (5th Cir. 1979) | 5, 6, 7 |
| Smith v. Commissioner, 66 T.C. 627 (1976) | 6 |
| Tennessee Valley Authority v. Hill, 437 U.S. 153 (1978) | 6 |
| Tilford v. Commissioner, 75 T.C. 134 (1980) | 6 |
| Tilford v. Commissioner, 705 F. 2d 828 (6th Cir. 1983) | 3 |
| United States v. Byrum, 408 U.S. 125 (1972) | 6 |
| Wright v. Commissioner, 18 B.T.A. 471 (1929), modified, 47 F. 2d 871 (7th Cir. 1931) | 5 |


**Statutes Cited:**


Internal Revenue Code of 1954, as amended:

Section 83 .....2, 3, 6

Section 165(c)(2) .....3, 4, 6

*Contents*

*Page*

Section 302 .....2, 3,

**Other Authority Cited:**

Note, Frantz or Fink: Unitary or Fractional View for Non-Prorata Stock Surrenders, 48 U.Pitt. L.Rev. ____ (forthcoming 1987) ..... 5



No. 86-511

In The

# Supreme Court of the United States

October Term, 1986

COMMISSIONER OF INTERNAL REVENUE,

*Petitioner,*

*vs.*

PETER R. FINK *et ux.*

*Respondent.*

*On Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit*

## BRIEF OF *AMICUS CURIAE*

### INTEREST OF THE *AMICUS CURIAE*

Leroy Frantz, Jr. files this *amicus* brief so that the administration of the tax law and its interpretation by the courts may remain intact and uniform. Mr. Frantz was a party in *Frantz v. Commissioner*, 83 T.C. 162 (1984), *aff'd*, 784 F. 2d 119 (2d Cir. 1986), the case in which the Tax Court abruptly announced its radical, unfounded departure from precedent dating back to

1929. The *Frantz* case and not *Fink v. Commissioner*, 789 F. 2d 427 (6th Cir. 1986) is the starting point in this appellate endeavor. Many of the points made by the Commissioner in this Court attempt to ignore or evade the findings of *Frantz* in its opinion in the Tax Court. Both parties to this appeal have consented to the filing of this *amicus* brief.

## ARGUMENT

The principle of tax law governing surrenders of stock in the companion cases of *Frantz* and *Fink* is relatively simple. However, due to the Tax Court's effort to accomplish more than precedent would allow, the simple solution has been abandoned in favor of fanciful theories ("fragmented" and "unitary") concerning allocation of basis. In order to lend credibility to the Commissioner's far-fetched, eleventh-hour arguments, irrelevant sections of the Internal Revenue Code of 1954, as amended, ("Code") have been introduced to the confusion of the real issues.

For example, Code section 302 dealing with the technical issue of classifying corporate distributions of property to shareholders as dividends or in exchange for stock is offered after having been considered and rejected by the Tax Court. Brief for the Petitioner, "Statute Involved," at 1. Actually, we would agree that what is needed to accomplish the change sought by the Commissioner may be a legislative counterpart to section 302 dealing specifically with, and providing a mechanical test for testing for loss on stock surrenders.

In addition, the petitioner incorrectly characterizes *J.K. Downer v. Commissioner*, 48 T.C. 86 (1967) as having been repudiated by the Tax Court. Petitioner's Brief at 20. Nothing could be further from the truth. In fact, *Downer* was never repudiated by the Tax Court. Its holding was changed legislatively by the Congressional enactment of section 83 of the Code in 1969,



which converted into a capital contribution the loss treatment previously accorded stock transfers or surrenders used to compensate employees. We also argue that the *Downer* experience is valuable precedent in the instant case. Rather than make a judicial change to established quasi-legislative precedent, Congressional action should be required to accomplish the change made incorrectly by the Tax Court in *Frantz*.

Far from repudiating *Downer*, the Tax Court first followed *Downer* and was reversed by the Sixth Circuit in *Tilford v. Commissioner*, 705 F. 2d 828 (6th Cir. 1983). It was the Sixth Circuit in *Tilford* which held that the Tax Court decisions in *Tilford* and *Downer*, both stock surrender-compensation cases, were of no further precedential value due to the intervention of Code section 83. No legislative change was made in the stock surrender cases outside the compensation area. The Sixth Circuit below in *Fink* was well qualified to explain its decision in *Tilford* and did so clearly.

The only Code section involved in this case is 165(c)(2). For well over 60 years it has provided for ordinary loss on dispositions of certain property not involving an exchange. It should be noted that the Commissioner voluntarily stipulated in *Frantz* that nothing was received in exchange for the stock surrender. Hence, it was conceded in *Frantz* from the outset that any loss would be ordinary as opposed to capital. The only real issue was the timing of the recognition of the loss, if loss was found. Capital loss was not an optional finding based on the facts of *Frantz*. Accordingly, section 302 and most of the array of authorities called up in support of the Commissioner's inconsistent arguments have no relevance to the matter decided by the Tax Court and the Courts of Appeals for the Second and Sixth Circuits.

Even if the stock surrender transactions in *Frantz* and *Fink* were thought for some good policy reason to be not proper

occasions for the recognition of ordinary loss, it would be an improper usurpation of the legislative function for the Tax Court or any other inferior court to change, without higher authority, a principle established and accepted by the legislative, judicial and administrative authorities. The principle upheld by the Sixth Circuit in *Fink* after its repudiation in *Frantz* has been extant for 55 years and is certainly one of the oldest and a relatively active precedent in the Tax Court's history. The issue was before the Court many times and was often considered by the full Court. It is an issue that can properly be called well settled.

The language of section 165(c)(2) was reenacted by Congress many times without substantial change from 1918 to the present time. The Internal Revenue Service itself had acquiesced in three pivotal holdings of the Tax Court allowing immediate loss on stock surrenders in 1941, 1942 and 1948. The first two acquiescences were only withdrawn in 1977, four years after the *Frantz* stock surrender and 36 years after the initial acquiescence. The last acquiescence is still on the books. *See Julius Miller v. Commissioner*, 45 B.T.A. 292 (1941), *acq.* 1941-2 C.B. 9, *nonacq.* 1977-1 C.B. 2; *Budd International Corp. v. Commissioner*, 45 B.T.A. 737 (1941), *acq.* 1942-2 C.B. 3, *nonacq.* 1977-1 C.B. 2, *rev'd on other issues*, 143 F. 2d 784 (3d Cir. 1944), *cert. denied*, 323 U.S. 802 (1945) and *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947), *acq.* 1948-1 C.B. 2.

It should be obvious after a close reading of the *Frantz* opinion in the Tax Court that the majority did not have any definite rationale. The opinion shifts from one principle to another in an attempt to cover too much ground. Ultimately, the Tax Court decision may only be rationalized on its stated fear that the transaction was tax-motivated. In this connection, the dissenting opinion by Judge Parker points out the other tools available to the Commissioner in combating tax avoidance, an issue which was never raised seriously in either *Frantz*, or *Fink*.



In *Wright v. Commissioner*, 18 B.T.A. 471 (1929), *modified*, 47 F. 2d 871 (7th Cir. 1931) the Tax Court's predecessor, the Board of Tax Appeals, held that a stock surrender gave rise to an immediate loss. The opinion was well-reasoned and reviewed by the court. The rejected, dissenting theory in *Wright* considered the "open" transaction theory somewhat relied upon by the Tax Court majority in *Frantz*. Thirty-eight years later the dissent in *Downer* would echo the reasoning of the *Wright* dissent and would be again rejected by the full court.

The so-called "unitary" and "fragmented" approaches did not originate in the *Downer* decision. Brief for Petitioner at 20, 26. Their origin is not as important as the fact that the petitioner concedes it was Congress (not the Tax Court itself) that emasculated (repudiated) *Downer* shortly after its publication. As long as the present income tax system has treated units of property, they have each been assigned a fraction of the total cost or other basis for income tax purposes. It is submitted that there has been no such basis accounting theory as the unitary method employed in connection with the disposition of shares of stock. *See* Note, Frantz or Fink: Unitary or Fractional View for Non-Prorata Stock Surrenders, 48 U.Pitt L.Rev. ____ (forthcoming 1987).

The petitioner attempts to distinguish the sale of stock from its contribution to capital for purposes of applying the unitary basis accounting method. This begs the question and is not responsive to anything raised below either in *Fink* or *Frantz*. The petitioner also takes great liberty in characterizing as "superficial" and "ultimately erroneous" the Sixth Circuit's response in *Fink* to the truly superficial and flatly erroneous exposition on capital contribution found in *Schleppy v. Commissioner*, 601 F. 2d 196 (5th Cir. 1979), the case which did so much to cause this current state of confusion. Brief for Petitioner at 23. It is truly ironic to witness the attribution of such importance by the Tax Court

in *Frantz* to *Schleppy*, a decision that reversed an undoubtedly well-reasoned Tax Court decision [*sub nom Smith v. Commissioner*, 66 T.C. 627 (1976)] finding of ordinary loss on a stock surrender. Further, the *Schleppy* reversal was not immediately embraced. It was first ignored by the Tax Court when it decided *Tilford v. Commissioner*, 75 T.C. 134 (1980) against the Commissioner. Ultimately, *Tilford* was reversed by the Sixth Circuit solely because its fact pattern (compensatory transfers) had been pre-empted by Congressional enactment of Code section 83 in 1969.

*Schleppy* has been roundly criticized for its failure to grasp the basic elements of the stock surrender problem and its monumental misreading of one of the important stock surrender cases in the Tax Court, *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947), *acq.* 1948-1 C.B. 2. If *Schleppy* had understood *Foster*, it is fair to say that it would not have reversed the Tax Court, and the change in the non-compensatory stock surrenders made by *Frantz* in the Tax Court would have properly have been left to Congress. Finally, on the authority of *Tennessee Valley Authority v. Hill*, 437 U.S. 153 (1978) and *United States v. Byrum*, 408 U.S. 125 (1972) we ask this Court to guard against judicial intrusion into matters best left to the legislature. *Frantz* disturbed not only 55 years of its own Tax Court precedent, but intruded on decades of legislative approval of that precedent through reenactment of Code section 165(c)(2), not to mention the decades of administrative approval through acquiescence in, and implementation of that precedent.

In recommending *Frantz* over *Fink* as a vehicle for review by this Court, the petitioner knew that there was not the slightest indication that tax avoidance motivated the surrender in *Frantz*. On the contrary, the taxpayer in *Frantz* was acting within the law as known to the public. He was entitled to rely on the statute as interpreted by existing precedent as well as the outward



manifestation of acquiescence by the Commissioner of Internal Revenue. The *Frantz* surrender took place in 1973, many years before the withdrawal of the acquiescences by the Commissioner in 1977; before the *Schleppy* decision in 1979; and before publication of some 1975 tax article erroneously and immaterially advanced by petitioner as evidence of tax avoidance. The taxpayer in *Frantz* was treated retroactively and unfairly.

The dissenting opinion in *Frantz* was cognizant of the Tax Court's disregard of stare decisis, and the *Fink* decision below relied heavily on the doctrine of reenactment in citing *Florida National Guard v. Federal Labor Relations Authority*, 699 F. 2d 1082 (11th Cir.), *cert. denied*, 464 S. Ct. 1007 (1983).

## CONCLUSION

We urge this Court to affirm the Sixth Circuit decision in *Fink* and to reverse the decision of the Second Circuit in *Frantz*.

Respectfully submitted,

PATRICK J. CARR
*Attorney at Law*